

Who Will Manage the Managers?: The Investment Company Act's Antipyrarniding Provision and Its Effect on the Mutual Fund Industry

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While not attracting the attention of many scholars, the antipyrarniding provision (the "provision") of the Investment Company Act (the "Act") has had a profound role in the development of the mutual fund industry. The provision limits one mutual fund's ability to invest in another such fund. Following a discussion of the provision's restrictions on such investments, the author explores the historical and practical justifications underlying the Act and its amendments. The author examines the nexus between the rationale for enacting the provision and the effect of the statutory language. The provision is evaluated in terms of its efficacy in addressing the policy arguments put forth by the drafters: redemption pressure on portfolio funds, excessive concentration of financial power, layering of fees, and undue organizational complexities. An examination of the management sphere pinpoints how the provision may exacerbate mutual fund industry problems arising from separation of ownership and management. The author concludes that the provision's attempt to restrict the power of fund managers has not succeeded. The provision's ultimate effect has been a weakening of the fund governance process and the market for control of funds—important shareholder checks on fund managers' behavior.

The Investment Company Act's "antipyrarniding" provision—which prevents mutual funds from owning more than three percent of the shares of any other fund—has received little scholarly attention. Yet it appears the provision has affected the structure of the fund industry and the nature of mutual funds' governance process. Specifically, the provision may have led to the fragmentation of ownership of fund shares and the proliferation of mutual funds. This fragmentation, in turn, may be partially responsible for the high fees paid by fund investors and the exceptional profits enjoyed by fund managers.

This Article examines the goals and effects of the antipyrarniding provision. Part I summarizes the legal structure of a mutual fund and the current state of the fund industry. In Part II, this Article analyzes the text of the antipyrarniding provision in depth. Part III examines the history of the antipyrarniding provision, from its adoption as part of the Investment Company Act of 1940 to its amendment in 1996. In Part IV, the stated goals of the provision are

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examined. This Article shows that because the provision is not well drafted to accomplish these goals, questions arise about the provision's true purposes. Part V fits the antipyrarniding provision within the body of legal scholarship addressing the problems arising from separation of ownership and management of corporations. The conclusion is that the antipyrarniding provision has weakened two methods by which shareholders might control the behavior of their fund's manager: the fund governance process and the market for control of funds. The Article finishes by hypothesizing that, because of this weakening of monitoring mechanisms, the antipyrarniding provision may partially explain certain conditions in the fund industry.

I. BACKGROUND

A. *Definition of Mutual Fund*

Defined simply, a mutual fund is an entity that raises money from investors and invests the proceeds in securities.¹ The securities are owned by a separate legal entity that sells shares to investors. The shares entitle their owners to a pro rata interest in the pooled assets. The fund is managed by a board of directors elected by the fund's shareholders. The fund enters into a contract with an entity that manages the fund's investments for a fee, which is generally a percentage of assets under management. The manager is generally an affiliate of the entity that organized the fund and promoted its sale to investors.

Mutual funds are divided into two types. "Open-end" funds offer shares continuously and grant investors a right to redeem their shares on demand at their current value.² Open-end fund shares are not transferable. "Closed-end" funds, by contrast, do not offer a redemption right to investors, who may exit the fund only by selling shares on an exchange, as they would corporate stock.³ Closed-end funds do not offer shares for sale continuously as open-end funds do.

¹ For a detailed description of the structure of a mutual fund, see Wallace Wen Yeu Wang, *Corporate Versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 WASH. L. REV. 927 (1994).

² See Investment Company Act of 1940, 15 U.S.C. § 80a-5(a)(1) (1994) (stating that an open-end company is "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer"). The redemption right may be subject to limitations.

³ See *id.* § 80a-5(a)(2) (stating that a closed-end fund is "any management company other than an open-end company").

B. The Fund Industry

The role of mutual funds in the U.S. financial sector has grown dramatically in recent decades. The total assets held by mutual funds rose from \$448 million in 1940⁴ to about \$3.73 trillion in April 1997.⁵ Assets held by mutual funds have grown faster than those of any other financial intermediary.⁶ Although this growth has been widely discussed, two developments in the fund industry have not been explained: the significant increase in the number of mutual funds, and the increase in fund expense ratios.

In 1940, the year the Investment Company Act (the "Act") became law, there were sixty-eight mutual funds of all types operating.⁷ By April 1997, this number had grown to 6472.⁸ The number of funds thus grew at an average annual rate of approximately seventy-seven percent—more than twice the growth rate of fund assets.⁹ Although the average equity mutual fund grew over the 1970–1995 period, it did so less rapidly than did the value of the stock market.¹⁰ As the number of funds has increased, the fraction of total industry assets held by the average fund has significantly decreased.¹¹

This large increase in the number of funds and the relatively small increase in the size of the average fund are difficult to explain for several reasons. First, the significant economies of scale inherent in fund management¹² should create

⁴ See INVESTMENT CO. INST., *MUTUAL FUND FACT BOOK* 27 (36th ed. 1996).

⁵ See *Trends in Mutual Fund Investing April 1997* (visited Aug. 1997) <http://www.ici.org/facts_figures/trends_0497.html>; see also *The Seismic Shift in American Finance*, *ECONOMIST*, Oct. 21, 1995, at 75.

⁶ See INVESTMENT CO. INST., *supra* note 4, at 11.

⁷ See WILLIAM J. BAUMOL ET AL., *THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION* 8 (1990).

⁸ See *Trends in Mutual Fund Investing April 1997*, *supra* note 5.

⁹ See INVESTMENT CO. INST., *supra* note 4, at 120; see also Diana B. Henriques, *Seeking Data on Funds, Investors and Regulators Find Frustration*, *N.Y. TIMES*, Aug. 9, 1994, at A1, D2.

¹⁰ The average equity fund had approximately \$111 million in assets in 1978 and \$573 million in 1995, an increase by a factor of 5.2. See INVESTMENT CO. INST., *supra* note 4, at 119–20. During this time, the Standard and Poor's 500 Stock Price Index rose by a factor of 9. See *id.* at 101.

¹¹ The average fund in 1970 held about 0.3% of the \$47.6 billion invested in all stock and bond funds. In 1995, the average fund held only 0.02% of the \$2,067 billion invested in all such funds. See INVESTMENT CO. INST., *supra* note 4, at 34, 119.

¹² See WHARTON SCH. OF FIN. & COMMERCE, *A STUDY OF MUTUAL FUNDS*, H.R. REP. NO. 87-2274, pt. 1, at 29 (1962) [hereinafter "WHARTON STUDY"]; Robert W. McLeod & D.K. Malhotra, *A Re-Examination of the Effect of 12-B-1 Plans on Mutual Fund Expense Ratios*, 17 J. FIN. RES. 231 (1994); Michael L. Sapir & James A. Bernstein, *Reorganizations*

a strong incentive for growth in fund size. Such economies of scale result from the fact that the expenses associated with fund management increase more slowly than does the size of assets under management. Sources of economies of scale include savings resulting from larger securities trades and from more efficient utilization of investment analysis; computers; shareholder servicing, accounting, record-keeping and reporting systems; and legal services.¹³ While empirical study would be needed to assess whether the rate of growth is consistent with the economies of scale funds experience, the slow rate of growth of the average fund and the proliferation of funds in the face of economies of scale suggest that other external factors are shaping the structure of the fund industry.

Second, the increase in the number of funds occurred during a time of consolidation among banks and other financial intermediaries.¹⁴ Consolidation among banks is believed to have resulted at least in part from the presence of scale economies similar to those that apply to mutual funds.¹⁵

Third, it may be argued that the number of funds is excessive relative to the needs of fund investors. Focusing for the moment on stock funds alone, the system used by the Investment Company Institute (ICI), the fund industry's trade association,¹⁶ to classify funds based on investment objective divides such funds into twenty-one categories.¹⁷ A major financial magazine classifies stock

of *Investment Companies*, 50 BUS. LAW. 817 (1995) (listing funds' SEC filings that cite economies of scale as a benefit of consolidation of funds within a fund family); Carole Gould, *Fees—Front, Back and Sideways*, N.Y. TIMES, Mar. 15, 1992, § 3, at F14; Jeffrey M. Laderman, *Are Fund Managers Carving Themselves Too Fat a Slice?*, BUS. WK., Mar. 23, 1992, at 78.

¹³ See Martin J. Gruber, *Another Puzzle: The Growth in Actively Managed Mutual Funds*, 51 J. FIN. 783 (1996); Vineeta Anand, *Roberts Urges Review of Mutual Fund Fees*, PENSIONS & INVESTMENTS, Feb. 21, 1994, at 19. These economies of scale are part of the reason investors decide to invest through mutual funds (rather than holding individual stocks) in the first place.

¹⁴ See *Valuation of the Banking Industry*, CORP. GROWTH REP. (WKLY.), Apr. 22, 1996, at 8046, available in LEXIS, BusFin Library, API File ("The number of commercial banks has decreased from 14,400 in 1985 to 10,450 in 1995.").

¹⁵ See Ronald G. Burke, *The New Architecture of Financial Intermediation*, BANKING STRATEGIES, Mar.-Apr. 1997, at 4; Marilyn R. Seyman & Steven P. Williams, *Comment: To Stay Independent, Check Cost Structures*, AM. BANKER, Jan. 6, 1995, at 9.

¹⁶ The Investment Company Institute (ICI) members' assets account for approximately 90% of total industry assets. See letter from Investment Company Institute to Thomas S. Harman, Chief Counsel, Div. Inv. Management, SEC (Feb. 7, 1989).

¹⁷ See INVESTMENT CO. INST., *supra* note 4, at 19-21. The ICI identifies three categories of funds that invest in both stocks and bonds and eight categories of bond funds. See *id.*

funds into a total of sixty-three possible categories. These categorization systems suggest that the 2763 stock funds extant in April 1997 far exceed the degree of variety in investment options that investors need or even can comprehend.¹⁸

Another paradox of the fund industry has been fees. The average expense ratio¹⁹ of U.S. equity funds (calculated as a percentage of managed assets) approximately doubled during the past four decades, increasing substantially since the Securities and Exchange Commission (SEC) first identified excessive fees as a fund industry problem.²⁰ Evidence exists that the fees advisers charge mutual funds exceed investment management fees charged to other institutions, like pension funds, for comparable services.²¹

¹⁸ See Mark Bautz, *Investors Shout Bravo!*, MONEY, Feb. 1997, at 76 (dividing stock funds into "Aggressive Growth," "Growth and Income," "Capital Growth," "International," "Foreign Regional," and "Specialty and Total Return," and classifying each type by whether the companies in which the fund invests are small, medium, or large and whether the fund's investment "style" is "growth," "value," or a blend).

¹⁹ The expense ratio is the ratio of the sum of all costs of ownership of a fund to the fund's assets. See Wang, *supra* note 1, at 989. It includes the fee paid to the fund's adviser for management of the fund and its portfolio; administration costs, such as "record-keeping and transaction services" (which may or may not be included in the investment advisory contract); and "other operating expenses, such as custodial fees, taxes, legal and auditing expenses, . . . directors' fees," and marketing and distribution costs. *Id.* at 989-90. It can be difficult to properly allocate certain costs (such as marketing, distribution, legal, accounting, and research and analysis) incurred by a fund "family"—a group of funds managed by a single adviser—to a particular fund.

²⁰ See Riva Atlas, *Watch Those Costs*, FORBES, Aug. 30, 1993, at 112 (expense ratio rose from 0.79% in 1956 to 1.45% in 1993); see also Gould, *supra* note 12, at F14; Laderman, *supra* note 12, at 78; Ken Sheets, *How Fund Expenses Nick Your Profits*, Kiplinger's PERS. FIN. MAG., Apr. 1996, at 34 (average expense ratio rose from 1.17% of assets in 1985 to 1.45% in 1995); Ruth Simon, *Avoid Stock and Bond Funds with High Expenses*, BUFFALO NEWS, Mar. 6, 1995, at D10 [hereinafter Simon, *Avoid Stock and Bond Funds*] (diversified stock funds with average or below-average expense ratios outperformed those with above-average expenses by a margin larger than the expense differential); Walter L. Updegrave, *Why Funds Don't Do Better*, MONEY, Aug. 1995, at 58, 63 (from 1979 to 1995, expense ratios for diversified stock funds rose about 35% and those of taxable bond funds have increased 14%, while municipal bond fund expenses dropped 12%); Jason Zweig, *Your Funds May Be Making You Rich . . . But You're Also Getting Robbed*, MONEY, Jan. 1997, at 62, 64 (from 1986 to 1995, management fees as a percentage of assets under management increased 11.8% and overall expenses increased 22%); Erik R. Sirri & Peter Tufano, *Buying and Selling Mutual Funds: The Impact of Costly Search* 29 (table I) (Apr. 1997) (unpublished manuscript, on file with author) (annual expense ratios (excluding loads) of 690 funds with investment objective of aggressive growth, growth and income, or long-term growth was 0.96% in 1971 and 1.44% in 1990).

²¹ See REPORT OF THE SEC ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT

This increase in fees is also difficult to explain.²² Because of the scale economies discussed above, expenses (as a fraction of assets managed) should decline as assets grow. Because fees are customarily defined as a percentage of assets, if the size of a fund increased and the fee rate remained the same, managers would reap a windfall as their fees increased more than their expenses did. In fact, managers have on average increased their fees as a percentage of assets so that this windfall has been even greater. Finally, the increase in fund charges has occurred despite the appearance of technological improvements that appear to have reduced funds' operating costs.²³ All of these facts are consistent with the very high, and increasing, profits that fund managers earn.²⁴

A related paradox is fund investors' apparent lack of concern with fund expenses. Although investors tend to buy more of funds that reduce their fees, fee *increases* appear not to cause investors to sell their shares.²⁵ Indeed, some studies have found a positive correlation between expense ratios and fund inflows (i.e., the higher a fund's expenses, the more new investment it receives).²⁶ In addition, although investors are to some extent attracted by good

COMPANY GROWTH, H.R. REP. NO. 89-2337, at 311-24 (1966) [hereinafter "PPI REPORT"] (average advisory fee for mutual funds with assets of \$100 million or more is 0.45%, 7.5 times greater than the typical bank fee charged for managing pension funds and profit-sharing plans, which is 0.06%); WHARTON STUDY, H.R. REP. NO. 87-2274, pt. 1, at 29, 504 (1962); Saul Hansell, *J.P. Morgan Shifts Strategies to Buy a Stake in Fund Concern*, N.Y. TIMES, July 31, 1997, at C1, C8 (stating that fees paid and profits earned in investment management for individuals are higher than those for institutions); Simon, *Avoid Stock and Bond Funds*, *supra* note 20, at D10 (bond fund investment management fees average 0.65%, while pension funds and other institutions pay 0.3% for fixed-income portfolio management); *see also* Ruth Simon, *How Funds Get Rich at Your Expense*, MONEY, Feb. 1995, at 130, 132 [hereinafter Simon, *How Funds Get Rich*] ("from 1971 to 1993, . . . for every percentage point a typical equity fund spent on expenses, its return dropped by 1.9 points").

²² But *see* Russ Wiles, *Despite Surge in Earnings, Funds Decline to Cut Fees*, CHI. SUN-TIMES, Jan. 14, 1996, at 44 (increase in expenses is partly explained by new shareholder services, increasing number of new small funds, and replacement of up-front "loads" with 12(b)(1) charges).

²³ A possible measure of this decline in operating expenses may be the decline in expenses of stock index funds. Because these provide roughly the same customer services as actively managed funds (other than stock selection), it is reasonable to assume that a high percentage of their costs arise from administrative and other operating expenses. The average expense ratio of index funds matching the Standard and Poor's 500 Stock Price Index declined from 1.24% in 1985 to 0.45% in 1994. *See* Gruber, *supra* note 13, at 789, 790.

²⁴ *See infra* text accompanying notes 35-37.

²⁵ *See* Sirri & Tufano, *supra* note 20, at 11.

²⁶ *See* Donald L. Santini & Jack W. Aber, *Investor Response to Mutual Fund Policy Variables*, 31 FIN. REV. 765, 767, 779 (1996).

fund performance (though this correlation is weak²⁷), the link between poor performance and fund outflows is relatively weak.²⁸ The result is that fund assets are somewhat "sticky." This apparent price-insensitivity is consistent with surveys showing that fund investors are largely ignorant of the expenses their funds charge.²⁹ Moreover, after fees are subtracted, the average mutual fund does not outperform unmanaged market indices.³⁰ This phenomenon appears especially significant in light of the documented and publicized inverse correlation between expenses and fund performance,³¹ as well as the high liquidity of fund shares.³² Given the ease of exit for open-end shareholders created by the redemption right, the apparent indifference of investors to a factor that has the potential to affect future performance is difficult to explain.³³ The fact that investors continue to add money to funds despite evidence that most actively managed funds do not beat comparable indexes also raises questions.³⁴

Fund managers' earnings are consistent with the high and increasing fees charged. Managers now enjoy a return on equity rivaled only by the most

²⁷ See *id.* at 766.

²⁸ See Keith C. Brown et al., *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. FIN. 85, 88 n.3 (1996) (citing a study); Edward B. Rock, *Foxes and Hen Houses?: Personal Trading by Mutual Fund Managers*, 73 WASH. U. L.Q. 1601, 1618-19 (1995); Sirri & Tufano, *supra* note 20, at 11.

²⁹ A survey by the SEC and the Office of the Comptroller of the Currency found that 80% of fund investors knew nothing about the expenses charged by their largest fund. See Zweig, *supra* note 20, at 65; see also *No Mourners for the Deadman Funds*, MUTUAL FUNDS, June 1997, at 62 (fund that declined in value by 84% since 1993 had an expense ratio of 25.6%); Updegrave, *supra* note 20, at 65 (82% of shareholders were satisfied with their funds' returns, 28.5% said "they [did not] measure their fund's performance against anything," and "28.9% and 27.1%, respectively, claimed they compared their funds' returns to what they could earn in [certificates of deposit] or to a specific percentage").

³⁰ See Yakou Amihud, *Open-End Mutual Funds in the United States of America*, in FUNDS AND PORTFOLIO MANAGEMENT INSTITUTIONS: AN INTERNATIONAL SURVEY 171, 180 (Stefano Preda ed., 1991).

³¹ See, e.g., Christopher R. Blake et al., *The Performance of Bond Mutual Funds*, 66 J. BUS. 371 (1993); Gruber, *supra* note 13, at 783; Zweig, *supra* note 20, at 64.

³² Transaction costs associated with exiting open-end funds are low because (1) the shares may be sold without brokers and (2) it is possible to use sale proceeds to purchase another fund, sometimes including a fund outside the family of the sold fund, by means of a single telephone call. See INVESTMENT CO. INST., *supra* note 4, at 40-41.

³³ See Rock, *supra* note 28, at 1626-27 (citing the possibility that the market for funds is imperfect due to the lack of sophistication of shareholders and difficulty in evaluating funds because they are composed of abstract legal rights).

³⁴ See generally Blake et al., *supra* note 31; Gruber, *supra* note 13.

profitable financial and industrial companies.³⁵ Even in the 1960s, when funds' annual expenses were significantly lower than they are now, a report by the Wharton School of Finance and Commerce found that fund advisers' compensation was above the level one would expect in a competitive market.³⁶ This is especially difficult to understand given the absence of barriers to entry into the fund industry and economists' conclusion that at least the money-market segment of the fund market is competitive.³⁷

Yet another puzzling aspect of the fund industry is the significant, persistent discounts from net asset value at which closed-end funds typically trade.³⁸ Economists and others have long been intrigued by the persistence of discounts, but have yet to explain them satisfactorily.³⁹ Like high fees, discounts represent a problem that has resisted regulatory cures.⁴⁰

³⁵ Mutual funds' net profit margin is approximately 25%, while that of the average U.S. company is 7%. See Zweig, *supra* note 20, at 64, 70.

³⁶ See WHARTON STUDY, H.R. REP. NO. 87-2274, pt. 1, at 30 (1962); see also Simon, *How Funds Get Rich*, *supra* note 21, at 131 (reporting mutual fund's fees substantially in excess of expenses).

³⁷ See BAUMOL ET AL., *supra* note 7, at 117; Phillip R. Mack, *Recent Trends in the Mutual Fund Industry*, 79 FED. RES. BULL. 1001, 1004 (1993) (reporting that under Department of Justice antitrust criteria, an industry with a "Herfindahl index" of less than 1000 is considered unconcentrated; the Herfindahl index for the mutual fund industry was 500 in 1984 and 380 in 1992); Wang, *supra* note 1, at 979 (concluding that "the absence of redemption fees, high liquidity of mutual fund assets, and the exchange privileges within some mutual fund complexes have resulted in higher investor mobility and a competitive environment for mutual funds"; overcapacity and new competitors will create competitive pressure).

³⁸ See, e.g., Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 903 (1988) ("[D]iscounts on seasoned funds of 20% or more, persisting for five years or longer, have been common."); Tim Quinson, *Market for Closed End Funds Comes Up Short*, DENVER POST, July 29, 1996, at E3 (reporting that 82% of the nation's 510 closed-end funds trade at a discount); Russ Wiles, *Test Water Before Leaping into Closed-End Fund*, L.A. TIMES, Nov. 19, 1995, at D4 (indicating that 84% of closed-end mutual funds were selling at a discount).

³⁹ See SETH ANDERSON & JEFFERY BORN, CLOSED END INVESTMENT COMPANIES: ISSUES AND ANSWERS 131-35 (1992); Kraakman, *supra* note 38, at 903 (discussing discounts as a motivation for acquisitions); Burton G. Malkiel, *The Structure of Closed End Fund Discounts Revisited*, 21 J. PORTFOLIO MGMT. 32, 35 (1995) (listing economics literature addressing the discount question); Burton G. Malkiel, *The Valuation of Closed End Investment Company Shares*, 32 J. FIN. 847, 857-58 (1977).

⁴⁰ See *Request for Comments on Reform of the Regulation of Investment Companies*, Securities Act Release No. 6868, Exchange Act Release No. 28,124, Investment Company Act Release No. 17,534, Investment Advisors Act Release No. 1234, International Series Release No. 128, 55 Fed. Reg. 25,322, 25,331-32 (1990) (to be codified at 17 C.F.R. pt. 270) [hereinafter Request for Comments].

II. RESTRICTIONS ON INTERFUND INVESTMENTS

A. The Antipyridding Provision

The Act comprehensively regulates many aspects of fund operations.⁴¹ It imposes detailed disclosure and substantive requirements affecting such issues as corporate governance, capital structure, and permissible investments.⁴² The primary provision of the Act restricting investments by one mutual fund in another is the "antipyridding" provision, section 12(d)(1), which limits investments by mutual funds in other funds.⁴³

Section 12(d)(1)(A)⁴⁴ forbids any registered investment company from

⁴¹ Mutual funds fall within the Act's definitions of "investment company": "any issuer which is, holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities," and

any issuer which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of the issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Investment Company Act of 1940, 15 U.S.C.A. § 80a-3(a)(1)(A), (C) (West 1997).

⁴² See generally 3 TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS* ch. 21 (1980 & Supp. 1998); 3 THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* §§ 17.1, 17.8 (3d ed. 1995).

⁴³ For a detailed description of the antipyridding provision, see 3 FRANKEL, *supra* note 42, at 242-56.

⁴⁴ 15 U.S.C. § 80a-12(d)(1)(A) (1994). Section 12(d)(1)(A) provides that:

It shall be unlawful for any registered investment company (the "acquiring company") and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any other investment company (the "acquired company"), and for any investment company (the "acquiring company") and any company or companies controlled by such acquiring company to purchase or otherwise acquire any security issued by any registered investment company (the "acquired company"), if the acquiring company and any company or companies controlled by it immediately after such purchase or acquisition own in the aggregate—

- (I) more than 3 per centum of the total outstanding voting stock of the acquired company;
- (II) securities issued by the acquired company having an aggregate value in excess of 5 per centum of the value of the total assets of the acquiring company; or
- (III) securities issued by the acquired company and all other investment companies (other than Treasury stock of the acquiring company) having an aggregate value in excess of 10 per centum of the value of the total assets of the acquiring company.

acquiring securities of any other investment company (whether registered or not)⁴⁵ if the acquiring company (in combination with other companies managed by the same adviser)⁴⁶ would as a result of the acquisition own:

- (I) more than 3% of the outstanding voting stock of the acquired company;
- (II) shares of the acquired company with a value exceeding 5% of the acquiring company's total assets; or
- (III) shares of the acquired company which, in combination with shares of all other investment companies, have an aggregate value exceeding 10% of the total assets of the acquiring company.⁴⁷

Section 12(d)(1)(A) also forbids the converse: no investment company (whether registered or not)⁴⁸ may acquire shares of a registered investment company in violation of any of these three conditions. However, section 12(d)(1)(A) does not apply to purchases by an entity not required to register as an investment company under the Act, of shares of another such entity.⁴⁹

Section 12(d)(1)(B) approaches interfund transactions from the viewpoint of the investment company whose shares are being acquired. This provision forbids a registered open-end investment company from selling its shares to another investment company if the sale would cause the acquiring company to own more than three percent of the acquired company's voting stock, or would cause more than ten percent of the acquired company's voting stock to be owned by all investment companies in the aggregate.⁵⁰

⁴⁵ The Act defines an investment company as any company that is or holds itself as being engaged primarily in the business of investing, reinvesting, or trading in securities, or "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets" 15 U.S.C.A. § 80a-3(1)(A), (C) (West 1997). Investment companies are required to register with the SEC unless they are excused from doing so by, e.g., sections 3(b), 3(c), or 7 of the Act. *See* Investment Company Act Release No. 6440, 36 Fed. Reg. 8729, 8730 & n.4 (1971). But investment companies not required to register nevertheless fall within the coverage of section 12(d)(1)(A). *See id.* at 8730 & nn.6-7.

⁴⁶ *See* FundTrust, SEC No-Action Letter, May 26, 1987, *available in* LEXIS, FedSec Library, NoAct File, 1987 SEC No-Act. LEXIS 2085; OTF Equities, Inc., SEC No-Action Letter, Nov. 14, 1975, *available in* LEXIS, FedSec Library, NoAct File, 1975 SEC No-Act. LEXIS 2526.

⁴⁷ "[S]ecurities of . . . investment companies not registered under the Act are considered for the purpose of determining whether the ten percent limitation is exceeded." *See* Investment Company Act Release No. 6440, *supra* note 45, at 8730 & n.8.

⁴⁸ *See id.*

⁴⁹ *See id.*

⁵⁰ *See* 15 U.S.C. § 80a-12(d)(1)(B) (1994).

Section 12(d)(1)(C) controls investments in closed-end funds. This subsection makes it unlawful for any investment company to acquire shares of a registered closed-end investment company if, as a result of the transaction, the acquiring company and its affiliates would together own more than ten percent of the voting stock of the closed-end company.⁵¹ The acquiring companies subject to this restriction include both closed- and open-end funds, and both registered investment companies and those not required to register.⁵²

Sections 12(d)(1)(E), (F), (G), and (J) provide exceptions from the restrictions of sections 12(d)(1)(A)–(C). Section 12(d)(1)(F) eliminates the restrictions in section 12(d)(1)(A)(ii)–(iii)—which focus on the size of the investment in relation to the acquiring company—if the acquiring and the acquired funds comply with certain conditions.⁵³ To use the exemption, the acquiring fund (together with its affiliates)⁵⁴ must limit its investment to three percent of the acquired company's stock.⁵⁵ The acquiring company also must not sell its own shares to the public using a sales load above 1.5%.⁵⁶ In addition, if an acquisition in reliance on this exemption takes place, two consequences arise: (1) the acquired fund is absolved of any obligation to redeem its shares in an amount exceeding one percent of its assets during any thirty-day period,⁵⁷ and (2) the acquiring fund is required to vote its shares of the acquired fund either according to the instructions of the acquiring fund's shareholders or in proportion to the vote of other shareholders of the acquired fund.⁵⁸ Because section 12(d)(1)(F) is available only if the acquiring company is a registered investment company,⁵⁹ unregistered investment companies such as foreign funds and private investment funds⁶⁰ must still comply with these restrictions.

Section 12(d)(1)(E) permits a fund to acquire shares of another fund if the

⁵¹ See *id.* § 80a-12(d)(1)(C).

⁵² See Investment Company Act Release No. 6440, *supra* note 45, at 8730.

⁵³ See 15 U.S.C.A. § 80a-12(d)(1)(F) (West 1997).

⁵⁴ "Affiliate" is defined in § 2(a)(3) of the Act. See 15 U.S.C. § 80a-2(a)(3) (1994). The SEC views the fact that two funds are managed by a common adviser as providing a "strong," though not determinative, indication that the funds are affiliates, resulting in aggregation of their holdings for purposes of § 12(d)(1). See *FundTrust*, *supra* note 46.

⁵⁵ See 15 U.S.C.A. § 80a-12(d)(1)(F)(i) (West 1997).

⁵⁶ See *id.* § 80a-12(d)(1)(F)(ii).

⁵⁷ See *id.* § 80a-12(d)(1)(F).

⁵⁸ See *id.* §§ 80a-12(d)(1)(F), 12(d)(1)(E)(iii)(aa).

⁵⁹ See *id.* § 80a-12(d)(1)(F).

⁶⁰ See *infra* notes 133–34 and accompanying text.

acquired shares are the only security owned by the acquiring fund.⁶¹ This exemption has allowed the creation of "master-feeder" funds—funds whose only shareholders are other investment companies, which in turn offer shares to the public.⁶²

Section 12(d)(1)(G) is a new exception to the antipyridding provision that allows the creation of "hub-and-spoke" funds.⁶³ These are mutual funds that invest entirely in the shares of other funds in the same fund group. Finally, section 12(d)(1)(J) permits the SEC to exempt interfund transactions from the strictures of section 12(d)(1).⁶⁴

B. Additional Restrictions on Interfund Transactions: Section 17

In addition to section 12(d)(1), section 17 of the Act also effectively restricts interfund acquisitions. Section 17(a) makes it unlawful for an "affiliated person" of a registered investment company to sell securities to, or purchase securities from, the company.⁶⁵ An investment company that owns five percent or more of the stock of another investment company or otherwise controlled it (e.g., through shared officers or directors) would be an affiliate of the latter,⁶⁶ as would the manager of the acquiring company and other funds managed by that adviser.⁶⁷ In addition, Rule 17d-1 under the Act⁶⁸ prohibits joint arrangements or enterprises between investment companies and affiliated persons. Once they are deemed affiliated, further investments by the acquiring fund are prohibited.⁶⁹

These provisions present numerous obstacles for interfund acquisitions. Once the five percent threshold is passed, no further purchases or sales by either fund of shares of the other fund would be allowed without SEC

⁶¹ See 15 U.S.C.A. § 80a-12(d)(1)(E)(ii) (West 1997).

⁶² See, e.g., South Asia Portfolio, SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,331, at 77,671 (Mar. 12, 1997).

⁶³ See *infra* note 124 and accompanying text.

⁶⁴ See 15 U.S.C. § 80a-12(d)(1)(J) (1994).

⁶⁵ See *id.* § 80a-17(a)(1), (a)(2), (b)(1). See generally 3 HAZEN, *supra* note 42, § 17.7, at 207-10.

⁶⁶ See, e.g., 15 U.S.C. § 80a-2(a)(3)(A); see also The Phoenix Funds, SEC No-Action Letter, Oct. 28, 1991, available in LEXIS, FedSec Library, NoAct File, 1991 SEC No-Act. LEXIS 1273; Vanguard STAR Fund et al., SEC No-Action Letter, 60 Fed. Reg. 50,656, 50,659 (1995).

⁶⁷ See 15 U.S.C. § 80a-2(a)(3)(C).

⁶⁸ 17 C.F.R. § 270.17d-1(a) (1997).

⁶⁹ See *id.* Purchases by the target fund of shares of the acquiring fund would also be prohibited. See *id.*

exemption. In addition, by causing the funds to become affiliates, a five percent acquisition would prevent “joint transactions” and “joint enterprises” by the funds. The uncertainty created by the notoriously vague contours of these terms would throw many areas of fund operations into question.⁷⁰ This prohibition might, for example, forbid the funds from investing in stock of the same company.⁷¹

III. HISTORY OF THE ANTIPYRAMIDING PROVISION

A. *The Adoption of the Act in 1940*

The Act was one of several Depression-era laws designed to combat the perceived evils of concentrated control over money and business.⁷² As Professor Roe has explained, a political consensus of the 1930s—and one that still resonates today⁷³—held that “organized money” controlled too much of the nation’s business, granting it excessive political power.⁷⁴ This political attitude gave rise to an array of statutes designed to directly limit the ability of “Wall Street financiers” to control the nation’s industries and to do so indirectly by imposing restraints on the size and power of banks, mutual funds, and other financial institutions.⁷⁵

As applied to mutual funds, the legislative agenda addressing the perceived problem of concentration of financial power took several forms. Although funds’ domination of banks and operating companies (i.e., corporations other than mutual funds) was the major fear,⁷⁶ the concentrated control of mutual

⁷⁰ See 3 HAZEN, *supra* note 42, § 17.7.

⁷¹ See, e.g., SEC v. Midwest Technical Dev. Corp., [1961–1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,252, at 94,147 (D. Minn. 1963); cf. Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985, 1001 (1993).

⁷² See, e.g., COMMITTEE ON BANKING & CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 73-1455, at 333–34 (1934) (known as the “Pecora Report,” the report stated that “[t]he investment company [has become] the instrumentality of financiers and industrialists to facilitate acquisition of concentrated control of the wealth and industries of the country.”).

⁷³ See, e.g., Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 44 (1991) [hereinafter Roe, *Political Theory*]; *House Panel Backs Some Mixing for Banking and Commerce*, N.Y. TIMES, June 18, 1997, at D8 (reporting Rep. Leach’s concern for “concentration of economic power”).

⁷⁴ See Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1469–70, 1491–92 (1991) [hereinafter Roe, *Political Elements*]; Roe, *Political Theory*, *supra* note 73, at 19–21.

⁷⁵ See Roe, *Political Elements*, *supra* note 74, at 1485.

⁷⁶ See *id.* at 1469.

funds by fund holding companies was also a concern.⁷⁷ Congress believed a fund holding company might exercise excessive influence over the funds in which it had invested, the companies whose securities the underlying funds owned, and the securities markets generally.⁷⁸ Even though mutual funds were then only small players in the financial arena,⁷⁹ the size of mutual funds was a concern: the SEC sought to prevent all funds from exceeding \$150 million in assets.⁸⁰ Though this proposal was not accepted, Congress did authorize the SEC to monitor the growth of mutual funds and conduct studies to determine whether their growth could lead to excessive concentration of wealth or otherwise could harm the public interest.⁸¹

Another reason for Congress's hostility toward interfund investments was its concern that the holding company structure and the "layering" of fees resulted in higher total fees for shareholders of the holding company.⁸² The SEC reported to Congress that shareholders in the top tier of a fund holding company paid higher total costs because they in effect paid for the charges—advisory fees, administrative expenses, and sales loads—of both the fund they owned directly and the funds it owned.⁸³ Congress also believed that the "undue organizational complexities"⁸⁴ of fund holding companies made it difficult for unsophisticated shareholders to understand and evaluate their

⁷⁷ See Investment Company Act of 1940, 15 U.S.C. § 80a-1(b)(4) (1994) (public interest is adversely affected when "control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed"); *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 112-13, 238-39 (1940) [hereinafter *Hearings*] (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC) (section 12(d)(1) is intended to prevent "abuses" including "the acquiring fund imposing undue influence over the management of the acquired funds through . . . the acquisition by the acquiring company of voting control of the acquired company"); HUGH BULLOCK, *THE STORY OF INVESTMENT COMPANIES* 34-36, 84 (1959).

⁷⁸ See PPI REPORT, H.R. REP. NO. 89-2337, at 317 (1966).

⁷⁹ See LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION*, ch. 1.H.6.c (1996).

⁸⁰ See *Hearings*, *supra* note 77, at 188, 375, 400-01, 412; Roe, *Political Elements*, *supra* note 74, at 1469.

⁸¹ See 15 U.S.C. § 80a-14(b) (directing the SEC to study whether growth of funds affects "concentration of control of wealth and industry"). This study became the *Wharton Study*, *supra* note 12. See also Investment Company Act Release No. 2729, June 13, 1958, available in LEXIS, FedSec Library, SecRel File, 1958 SEC LEXIS 399.

⁸² See *Hearings*, *supra* note 77, at 238 (statement of David Schenker); 76 CONG. REC. S2844 (Mar. 14, 1940) (remarks of Sen. Wagner); 3 FRANKEL, *supra* note 42, at 238.

⁸³ See Vanguard STAR Fund et al., *supra* note 66; 3 FRANKEL, *supra* note 42, at 238.

⁸⁴ *Hearings*, *supra* note 77, at 238-39 (statement of David Schenker); 76 CONG. REC. S2844-45 (Mar. 14, 1940) (remarks of Sen. Wagner).

investments.⁸⁵

Conflicts of interest perceived to arise when one fund owned a significant stake in another were an additional concern.⁸⁶ The main problem envisioned was the damage to the underlying fund caused by large redemptions or threats of redemptions by the acquiring fund.⁸⁷ The Act expressed these fears by declaring that "the national public interest and the interest of investors are adversely affected" when "investment companies are . . . managed in the interest of other investment companies . . . rather than in the interest of all classes of such companies' security holders."⁸⁸ Similar concerns led to the inclusion of section 17(a) in the Act. Congress adopted that section to "protect[] 'minority interests from exploitation by insiders of *their* strategic position' and assure[] that interested persons deal with the investment company 'at arm's length in an endeavor to secure the best possible bargain for their respective stockholders.'"⁸⁹

The SEC's original draft of section 12(d)(1) prohibited an investment company from acquiring any securities of another investment company.⁹⁰ The industry supported strict limitations on interfund acquisitions. However, the SEC and the industry agreed to allow limited interfund investments, because such investments might represent a source of profits for funds and apparently because the problem of fund holding companies was not believed to be significant.⁹¹ Thus, the antipyrarniding provision adopted in 1940 prohibited an investment company from purchasing more than five percent of the voting stock of another investment company whose investments were concentrated in a single industry, or more than three percent of the voting stock of any other type of investment company.⁹² This provision did not limit the fraction of the acquiring company's assets that could be invested in other investment

⁸⁵ See T. Rowe Price Spectrum Fund, Inc., et al., Notice of Application, 60 Fed. Reg. 50,654, 50,655 (1995); cf. Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303, 325 (1941).

⁸⁶ See Investment Company Act of 1940, 15 U.S.C. § 80a-1(b)(2) (1994).

⁸⁷ See *Hearings*, *supra* note 77, at 780-81 (statement of Prof. E. Merrick Dodd, Jr.); PPI REPORT, H.R. REP. NO. 89-2337, at 311-24 (1966). For further discussion of this issue, see *infra* text accompanying notes 106-12 and Part IV.A.

⁸⁸ 15 U.S.C. § 80a-1(b)(2).

⁸⁹ 3 HAZEN, *supra* note 42, § 17.7, at 204 (footnote omitted) (quoting E.I. du Pont de Nemours & Co. v. Collins, 432 U.S. 46, 60 n.6 (1977) (Brennan, J., dissenting)).

⁹⁰ See *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 10 (1940); 3 FRANKEL, *supra* note 42, at 238.

⁹¹ See *Hearings*, *supra* note 77, at 1055; 3 FRANKEL, *supra* note 42, at 239.

⁹² See Investment Company Act of 1940 § 12(d)(1), ch. 686, 54 Stat. 789, 809 (current version at 15 U.S.C.A. § 80a-12(d)(1) (West 1997)).

companies.⁹³ In addition, the provision applied only to purchases by registered investment companies.⁹⁴

B. 1970 Amendment

Congress amended the Act in 1970 following the SEC's delivery of a report ("*PPI Report*") recommending legislative remedies to address a number of perceived fund industry problems.⁹⁵ One such problem was the growth of fund holding companies since the 1930s. The SEC's concerns about this growth fell into two categories. Its primary concern was with the growth of foreign fund holding companies, in particular Fund of Funds Ltd. ("Fund of Funds"), the largest such holding company then in operation.⁹⁶ Fund of Funds was an open-end investment company incorporated in Ontario, headquartered in Geneva, and sponsored by IOS Ltd. (S.A.), a Panamanian corporation also headquartered in Geneva.⁹⁷ The SEC was concerned about the rapid growth and absolute size of Fund of Funds. Its assets exceeded \$420 million,⁹⁸ at a time when the entire industry's assets were about \$38 billion.⁹⁹ Fund of Funds owned one-hundred percent of the shares of four domestic funds, more than thirty percent of the shares of eight other domestic funds, and part of several mutual fund management companies.¹⁰⁰ Fund of Funds' investments in U.S. funds were possible because, as noted above, before 1970, section 12(d)(1) did not restrict interfund investments by investment companies exempt from the Act's registration requirement, such as foreign funds.¹⁰¹

The SEC's second concern was with the appearance of fund holding companies that owned open-end funds. Fund holding companies in the 1930s owned only closed-end companies.¹⁰² The SEC was concerned, as it had been during adoption of the 1940 Act, that this new type of holding company might "exert undue influence or control over" the open-end funds in which it owned

⁹³ See *id.*

⁹⁴ See *id.*

⁹⁵ See PPI REPORT, H.R. REP. NO. 89-2337 (1966). See generally LOSS & SELIGMAN, *supra* note 79, at ch. 1.H.6.c.

⁹⁶ See PPI REPORT, H.R. REP. NO. 89-2337, at 312.

⁹⁷ See *id.*

⁹⁸ See *id.* at 312-13.

⁹⁹ See Investment Company Act Release No. 4766, Dec. 2, 1966, available in LEXIS, FedSec Library, SecRel File, 1966 SEC LEXIS 377, at *2.

¹⁰⁰ See PPI REPORT, H.R. REP. NO. 89-2337, at 312-14; Richard Phalon, *Funds Investing in Others Scored*, N.Y. TIMES, Dec. 3, 1966, at 63.

¹⁰¹ See PPI REPORT, H.R. REP. NO. 89-2337, at 312.

¹⁰² See *id.* at 311 n.16.

shares.¹⁰³ The SEC believed this control might enable the holding company to take controlling positions in securities held by its portfolio funds if several of those funds held stakes in a single issuer—giving the holding company influence not only over the underlying issuers but also over the stock market in general.¹⁰⁴ Such control was especially worrisome, the SEC said, when the holding company was foreign, since foreign companies could hide their owners' identities from U.S. authorities.¹⁰⁵

The primary problem the SEC identified as resulting from holding company influence at this time was large redemptions or threats of redemption by the holding company.¹⁰⁶ The SEC theorized—without citing any historical evidence—that the holding company, by threat of redemption or directly through the acquisition of voting control, might induce a portfolio fund to change its investment policies from those adopted by the fund manager.¹⁰⁷ The SEC also accepted the ICI's argument that a fund with a significant holding company investor would be forced to anticipate a large redemption by the holding company by taking steps such as keeping a large percentage of its assets in cash or liquidating a large chunk of its assets in a short time.¹⁰⁸ The ICI contended the latter action would work against other shareholders' interests because of the need to hold nonoptimal amounts in cash and because of the losses from a distress sale.¹⁰⁹ These problems, the SEC believed, could be magnified when the holding company shareholders were foreign entities because their redemption behavior would be influenced by foreign political and economic developments "not really relevant to investment in domestic mutual funds."¹¹⁰ In addition, the SEC contended that foreign investors' redemption

¹⁰³ *Id.* at 315; see also Frank Russell Investment Companies, SEC No-Action Letter, Jan. 3, 1984, available in LEXIS, FedSec Library, NoAct File, 1984 SEC No-Act. LEXIS 1517 (allowing Canadian pension funds to acquire more than 3% of registered mutual funds on the condition that the pension fund would not seek to control or change policies of underlying funds).

¹⁰⁴ See PPI REPORT, H.R. REP. NO. 89-2337, at 315-17.

¹⁰⁵ See *id.* at 312; Phalon, *supra* note 100, at 63.

¹⁰⁶ See PPI REPORT, H.R. REP. NO. 89-2337, at 315; see also Roe, *Political Theory*, *supra* note 73, at 19.

¹⁰⁷ See PPI REPORT, H.R. REP. NO. 89-2337, at 316; see also *Bancroft Convertible Fund, Inc. v. Zico Investment Holdings, Inc.*, 825 F.2d 731, 738-39 (3d Cir. 1987); *Clemente Global Growth Fund, Inc. v. Pickens*, 705 F. Supp. 958 (S.D.N.Y. 1989) (target fund has an interest in preventing the acquiring fund from "radically alter[ing] the [target] Fund's investment objectives and policies").

¹⁰⁸ See PPI REPORT, H.R. REP. NO. 89-2337, at 316-17.

¹⁰⁹ See *id.* at 317.

¹¹⁰ *Id.* at 318.

behavior was likely to affect several foreign fund holding companies simultaneously, and thus to have multiplier effects on U.S. markets.¹¹¹ It appears the SEC's opinion about the harmful potential of foreign fund holding companies was influenced by the well-publicized securities law violations of Fund of Funds and by the holding company's ultimate collapse.¹¹²

The SEC was also concerned about "the unnecessary layering of costs"¹¹³ that it believed was inherent in the holding company structure.¹¹⁴ Investors in a fund holding company, the SEC believed, faced the prospect of paying advisory and administrative expenses, as well as sales loads, of both the holding company and its portfolio funds. The evidence the SEC cited to demonstrate the extent of the problem was, once again, Fund of Funds. The problem of layering of fees exacerbated the general problem of excessive fees paid by all fund investors.¹¹⁵

To remedy these perceived problems, the SEC for the second time proposed that section 12(d)(1) be tightened by applying it to foreign holding companies and eliminating its exception for interfund investments below three or five percent of the target's shares; under the SEC's proposal, interfund investments would have been flatly prohibited.¹¹⁶ The ICI opposed elimination of the three to five percent exception, but did not oppose application of section 12(d)(1) to unregistered investment companies.¹¹⁷ After years of legislative efforts, Congress accepted the ICI's approach, preserving the exception for small investments but extending the prohibition to unregistered funds.¹¹⁸ Congress also created a new exemption for "master-feeder" funds.¹¹⁹

¹¹¹ See *id.*

¹¹² See, e.g., *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir. 1975); In the Matter of I.O.S., Ltd., et al., Securities Exchange Act Release No. 8083, May 23, 1967, available in LEXIS, FedSec Library, SecRel File, 1967 SEC LEXIS 521; *Cornfeld Group to End U.S. Deals*, N.Y. TIMES, May 25, 1967, at 67; *Fund of Funds Loses a Round*, N.Y. TIMES, Oct. 5, 1966, at 61; *Rampant Capitalist Who Made Up His Own Rules: Obituary of Bernie Cornfeld*, FIN. TIMES (London), Mar. 2, 1995, at 4; David Yee, *The Ghost of Bernie Cornfeld*, FIN. WORLD, Apr. 25, 1995, at 71.

¹¹³ See PPI REPORT, H.R. REP. NO. 89-2337, at 319-20. The SEC contended that the excessiveness of these charges resulted from the absence of price competition in mutual fund marketing.

¹¹⁴ See Investment Company Act Release No. 4766, *supra* note 99.

¹¹⁵ See WHARTON STUDY, H.R. REP. NO. 87-2274, pt. 1, at 28-32 (1962).

¹¹⁶ See PPI REPORT, H.R. REP. NO. 89-2337, at 323.

¹¹⁷ See *Hearings on S.1659 Before Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 316-17 (1967).

¹¹⁸ See Investment Company Act Release No. 6440, *supra* note 45, at 8730 & n.8.

¹¹⁹ See *supra* text accompanying notes 61-62.

C. 1996 Amendment

The National Securities Market Improvements Act of 1996¹²⁰ added an additional exemption to section 12(d)(1). The new exemption, section 12(d)(1)(G),¹²¹ allows funds to purchase shares of other funds in excess of the three percent limit in section 12(d)(1)(A) if both funds are part of a single "group" of funds—e.g., a fund "family" like Fidelity or Dreyfus¹²²—and if the parent fund's only assets are shares of funds in the group to which the parent belongs. The exemption is available only for open-end funds that own shares of other open-end funds.¹²³ This amendment codified previous SEC no-action

¹²⁰ Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of 15 U.S.C.A. and 29 U.S.C.A. § 1002).

¹²¹ The new exemption, section 12(d)(1)(G), provides:

(G)(i) This paragraph does not apply to securities of a registered open-end investment company or a registered unit investment trust (hereinafter in this subparagraph referred to as the "acquired company") purchased or otherwise acquired by a registered open-end company or a registered unit investment trust (hereinafter in this subparagraph referred to as the "acquiring company") if—

(I) the acquired company and the acquiring company are part of the same group of investment companies;

(II) the securities of the acquired company, securities of other registered open-end investment companies and registered unit investment trusts that are part of the same group of investment companies, Government securities, and short-term paper are the only investments held by the acquiring company;

(III) with respect to—

(aa) securities of the acquired company, the acquiring company does not pay and is not assessed any charges or fees for distribution-related activities, unless the acquiring company does not charge a sales load or other fees or charges for distribution-related activities; or

(bb) securities of the acquiring company, any sales loads and other distribution-related fees charged, when aggregated with any sales load and distribution-related fees paid by the acquiring company with respect to securities of the acquired fund, are not excessive under rules adopted pursuant to [certain sections of] this title, or the Commission;

(IV) the acquired company has a policy that prohibits it from acquiring any securities of registered open-end companies or registered unit investment trusts in reliance on this subparagraph or subparagraph (F); . . .

National Securities Market Improvements Act of 1996, 15 U.S.C.A. § 80a-12(d)(1)(G) (West 1997).

¹²² The amendment defines a fund group as two or more funds that "hold themselves out to investors as related companies for purposes of investment and investor services." *Id.* § 80a-12(d)(1)(G)(ii).

¹²³ See *id.* § 80a-12(d)(1)(G)(i). In addition, the acquired fund's right to own shares of other funds is limited and the aggregate sales loads and other distribution fees charged by the

positions allowing the creation of "hub-and-spoke" funds.¹²⁴

The 1996 amendment also empowered the SEC to grant exemptions to section 12(d)(1).¹²⁵ Congress directed the SEC to slowly expand the types of fund holding company arrangements that would qualify for this exemption, yet to continue to protect investors by forbidding arrangements giving rise to the abuses that originally motivated section 12(d)(1), such as "conflicts of interest and overreaching by a participant in the arrangement."¹²⁶ As an example of the type of situation in which the SEC might use its exemptive authority, the committee report cites funds not part of a large fund group; unlike large fund complexes, such funds cannot create a fund of funds unless they own shares in unaffiliated funds.¹²⁷ The SEC to date has narrowly interpreted its authority under this provision.¹²⁸

The changes to the antipyrarniding provision were not a major focus of legislative debate concerning the 1996 amendment. The ICI appears to have been the only interest group to have taken a position on antipyrarniding issues during debate on the 1996 amendment.¹²⁹ The argument in support of the new

two funds must not be excessive. *See id.* § 80a-12(d)(1)(G)(i)(II), (III)(bb).

¹²⁴ *See* "Hub-and-Spoke" Funds: A Report Prepared by the Division of Investment Management, enclosure to Committee on Energy and Commerce, U.S. House of Representatives, SEC No-Action Letter, Apr. 15, 1992, *available in* LEXIS, FedSec Library, NoAct File, 1993 SEC No-Act. LEXIS 766 [hereinafter "Hub-and-Spoke Report"]. The no-action letters had allowed interfund investments if both funds were "part of a group of investment companies which holds itself out to investors as related companies for purposes of investment and investor services" and obtained management, administrative, and distribution services from a common entity. *See, e.g.*, T. Rowe Price Spectrum Fund, Inc., Investment Company Act Release No. 21,425, Oct. 18, 1995, *available in* LEXIS, FedSec Library, SecRel File, 1995 SEC LEXIS 2857; Vanguard STAR Fund, Investment Company Act Release No. 21,426, Oct. 18, 1995, *available in* LEXIS, FedSec Library, SecRel File, 1995 SEC LEXIS 2860.

Before enactment of the 1996 amendment, 37 such funds existed. *See* Alejandro Bodipo-Memba, "Fund of Funds," *Sullied by 1960s Fiasco, Will Get Shot in Arm from Securities Bill*, WALL ST. J., Aug. 16, 1996, at C1.

¹²⁵ *See* 15 U.S.C.A. § 80a-12(d)(1)(J) (West 1997).

¹²⁶ H.R. REP. NO. 104-622, at 44 (1996).

¹²⁷ *See id.* at 43.

¹²⁸ *See, e.g.*, SBSF Funds, Inc., d/b/a Key Mutual Funds et al., Notice of Application, Investment Company Act Release Nos. 22,486, 812-10164, Jan. 30, 1997, *available in* LEXIS, FedSec Library, SecRel File, 1997 SEC LEXIS 227; Liberty Term Trust, Inc.-1999, Investment Company Act Release Nos. 22,465, 812-10404, 62 Fed. Reg. 3066 (1997).

¹²⁹ *See Institute Supports Bill Modernizing Fund Regulation*, ICI News Release, Apr. 7, 1995 (supporting Rep. Fields's Investment Company Act Amendments of 1995, the antipyrarniding provisions which were similar to the final 1996 amendment); *Congressional*

“hub-and-spoke” exemption cited the potential benefits shareholders of the holding company could derive from its investment in other funds. The perceived advantages were (1) the holding company could benefit from the services of specialized managers (e.g., advisers knowledgeable in foreign markets) selected by the manager of the holding company fund and (2) shareholders of the holding company could enjoy the advantages of additional diversification.¹³⁰ These goals fit within the Act’s overall stated purpose of improving the efficiency of the capital markets.¹³¹ Congress also was apparently persuaded that the restrictions the SEC had imposed on affiliated “hub-and-spoke” funds were adequate to address the problems the antipyridding provision sought to address, “such as overly complex corporate structures and excessive distribution fees.”¹³²

Yet despite this deregulatory rhetoric, the 1996 amendment significantly tightened the antipyridding provision in another respect. Before the 1996 amendment, although the Act’s language was ambiguous, it had been interpreted as applying the antipyridding provision to private investment funds—those generally with fewer than 100 investors.¹³³ The 1996 amendment extended the provision’s coverage to include such private funds as well as a new category of private funds created by the 1996 amendment.¹³⁴

IV. THE RATIONALE FOR THE ANTIPYRAMIDING PROVISION

A detailed comparison of the stated rationale for adoption of section 12(d)(1), as set forth in the legislative history for the original Act and its amendments, with the structure and language of the provision indicates significant divergences between the two. The following discussion summarizes the major policy arguments put forward by supporters of section 12(d)(1)—harms from redemption pressures, concentration of financial power, layering of fees, and undue organizational complexities—and examines whether the

Hearings on HR 1495, The ICA Amendments of 95, ICI memorandum, Nov. 8, 1995 (fund representative supporting expansion of fund-of-fund exemption limited to fund families).

¹³⁰ See 141 CONG. REC. E868 (daily ed. Apr. 7, 1995) (remarks of Rep. Fields).

¹³¹ The 1996 amendment was designed “to promote more efficient management of mutual funds, protect investors, and provide more effective and less burdensome regulation . . .” H.R. CONF. REP. NO. 104-864, at 39 (1996).

¹³² S. REP. NO. 104-293, at 7 (1996); see H. REP. NO. 104-622, at 43 (1996) (provision preventing hub-and-spoke funds from investing in unaffiliated funds “is intended to avoid overly complex inter-corporate structures”).

¹³³ See *Clemente Global Growth Fund, Inc. v. Pickens*, 705 F. Supp. 958, 964 (S.D.N.Y. 1989).

¹³⁴ See Investment Company Act of 1940, 15 U.S.C. §§ 80a-3(c)(1), (c)(7)(C) (1994).

provision as drafted addresses these arguments.

A. Redemption Pressure on Portfolio Funds

As shown above, harms resulting from redemption pressures were a significant concern of the proponents of the antipyridding provision. The concern was that, in the event the holding company redeemed its holdings in the portfolio fund en masse, the portfolio fund might be forced to sell its assets in a hasty manner.¹³⁵ This might produce low sale prices, hurting other shareholders of the portfolio fund. In addition, the mere knowledge that a large-scale redemption was possible might force the subsidiary fund to maintain a larger cash position than its investment strategy would otherwise dictate. In either event, shareholders of the portfolio fund might suffer.

Congress also feared that large-scale redemptions by the holding company might have a domino effect on the securities markets generally.¹³⁶ The fear was especially great when the holding company was foreign, because it was thought that allowing significant ownership of U.S. funds by foreign entities could expose U.S. markets to the volatility of foreign markets.¹³⁷ The well-publicized collapse of Fund of Funds and its affiliates contributed to the belief that pyramiding involving foreign holding companies could endanger the stability of the U.S. financial system.¹³⁸

Yet history and logic seem not to bear these fears out. First, the Act already contains several provisions designed to address the problems that may result from large, rapid redemptions. These include liquidity requirements;¹³⁹

¹³⁵ See, e.g., South Asia Portfolio, *supra* note 62, at 77,673 ("the undue influence over the adviser of the controlled company through the threat of large scale redemptions and loss of advisory fees to the adviser, resulting in the disruption of the orderly management of the company through the maintenance of large cash balances to meet potential redemptions . . .").

¹³⁶ Cf. Rock, *supra* note 28, at 1617-18 (the SEC's desire to preserve the fund industry's appearance of integrity so that investors maintain confidence, thereby preserving the social benefits of the fund industry).

¹³⁷ See PPI REPORT, H.R. REP. NO. 89-2337, at 318 (1966).

¹³⁸ See, e.g., Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 987-89 (2d Cir. 1975) (expert testimony that the IOS collapse resulted in a deterioration of domestic and foreign investor confidence, causing a "steep decline" in foreign purchases of U.S. securities, increased redemption of mutual fund shares, and a ripple effect that depressed the prices of American securities).

¹³⁹ To ensure that open-end funds have sufficient liquid assets to provide cash for redemptions, a maximum of 15% of such a fund's assets (10% for money market funds) may be invested in illiquid securities. See Robert A. Robertson & Bradley W. Paulson, *A Methodology for Mutual Fund Derivative Investments*, 1 STAN. J.L. BUS. & FIN. 237, 244

investment limitations;¹⁴⁰ debt restrictions;¹⁴¹ the ability to make pro rata distributions of unliquidated assets in emergency situations;¹⁴² and the ability to suspend redemptions altogether in special situations.¹⁴³

Second, market pressures already create incentives for managers of both parent and portfolio funds to prepare for the potentially harmful effects of redemptions.¹⁴⁴ For the manager of the portfolio fund, the most obvious incentive to minimize redemptions is that management fees (and perquisites) are in general proportional to fund size.¹⁴⁵ In addition, if, as antipyridding proponents assert, rapid redemptions may force distress selling of fund assets, managers have an incentive to prepare for or avoid such redemptions so as to enjoy the marketing benefits of a good performance record.¹⁴⁶ Among the tools available for doing so are maintaining liquidity in excess of legal requirements; establishing bank lines of credit; emergency borrowing; lending securities and cash between funds in a group; and imposing redemption fees or restrictions.¹⁴⁷

(1995). "An asset is 'illiquid' if a fund cannot sell the asset in the ordinary course of business within seven days at the approximate price at which the fund has valued the asset." *Id.*

¹⁴⁰ Funds calling themselves diversified may invest no more than 5% of their assets in the securities of a single issuer, and may not own more than 10% of the outstanding securities of a single issuer. See Investment Company Act of 1940, 15 U.S.C. § 80a-5(b)(1) (1994). Though couched as diversification requirements, these restrictions have the effect of increasing the liquidity of a diversified fund's investments because large blocks of stock of a single issuer are generally difficult to sell.

¹⁴¹ Section 18 of the Act prohibits registered investment companies from issuing senior debt securities, with some exceptions. See 15 U.S.C. § 80a-18(a), (f), (g). Because funds are generally not leveraged, the spill-over effects from a fund's collapse (e.g., due to large redemptions by its parent fund) are lower than, for example, those resulting from a bank failure. See Roe, *Political Elements*, *supra* note 74, at 1504.

¹⁴² See 15 U.S.C. § 80a-2(a)(32).

¹⁴³ See *id.* § 80a-22(e)(2).

¹⁴⁴ See T. Rowe Price Spectrum Fund, Inc., et al., Notice of Application, *supra* note 85, at 50,656 (portfolio funds "have maintained sufficient cash positions to satisfy all redemptions made by the Spectrum Fund"); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (to be prepared for redemptions, preservation of maximum liquidity must remain a high priority for the rational mutual fund manager).

¹⁴⁵ See Ajay Khorana, Sunil Wahal, & Marc Zenner, *Why Do Firms Issue Equity?: Rights Issues in the Closed-End Funds Industry* (Nov. 1996) (unpublished manuscript, on file with author).

¹⁴⁶ See Edward Wyatt, *To Fight a Crash, Funds Buttress Their Cash*, N.Y. TIMES, Sept. 24, 1995, § 3, at 1.

¹⁴⁷ See Tarun Chordia, *The Structure of Mutual Fund Charges*, 41 J. FIN. ECON. 3, 7, 32 (1996) (back-end fees dissuade redemptions); Charles Gasparino, *Mutual Funds Have Cash on Hand to Meet Withdrawals*, MINN.-ST. PAUL STAR TRIB., July 21, 1996, at 4D. See

In the *PPI Report*, the SEC appears to have concluded that the mechanisms available to funds to insulate themselves from redemption risks, though deemed adequate in the context of a single-tier fund, are inadequate in the context of a fund holding company. The SEC appears to have based this conclusion on the assumption that a fund holding company would be a less steady investor than, for example, an individual or another institutional investor because (1) the fund holding company might be forced to redeem its shares in the portfolio fund due to its statutory obligation to meet redemption demands from its own shareholders,¹⁴⁸ or (2) the fund holding company was a foreign fund.¹⁴⁹

But the *PPI Report* made little attempt to support these assumptions. Moreover, in related contexts, the SEC has accepted the argument that conflicts between the interests of parent and portfolio funds can be managed even when the portfolio fund is not wholly owned by the parent.¹⁵⁰ The SEC has also recognized the ability of liquidity requirements to protect against problems that might arise from redemption risks created by interfund investments.¹⁵¹

There is little reason to assume that funds are more likely to recklessly redeem their investment in another fund en masse than would other institutional investors.¹⁵² Yet the Act does not set limits on these entities' ownership of funds, and the SEC has been sanguine about the likelihood of institutional

generally Periodic Repurchases by Closed-End Management Investment Companies; Redemptions by Open-End Management Investment Companies and Registered Separate Accounts at Periodic Intervals or With Extended Payment, Securities Act Release No. 6948, Securities Exchange Act Release No. 30,967, Investment Company Act Release No. 18,869, 57 Fed. Reg. 34,701 (1992); E.F. Hutton Investment Series, Filing of Application, Investment Company Act Release No. 12,079, 46 Fed. Reg. 60,703, 60,705 (1981) (contingent deferred sales load deducted for redemptions within designated period).

¹⁴⁸ The holding company, if a registered fund, would be obligated by section 22(e) of the Act to redeem its securities within seven days. *See* Investment Company Act of 1940, 15 U.S.C. § 80a-22(e) (1994). As discussed below, it was also feared that the holding company might choose to redeem as a means of pressuring the portfolio fund into changing certain policies.

¹⁴⁹ *See supra* text accompanying note 111.

¹⁵⁰ *See* Brinson Relationship Funds et al., Investment Company Act Release No. 22,204, 61 Fed. Reg. 48,515, 48,517 (1996).

¹⁵¹ *See* Vanguard STAR Fund et al., *supra* note 66, at 50,659 (stating that because portfolios are 85% invested in liquid securities, "they would have no reason to hold a higher than normal cash position to protect their other shareholders against potential redemptions by" the spoke).

¹⁵² Among the institutions investing in mutual funds are insurance companies, corporations, nonprofit organizations, and fiduciaries (banks and individuals serving as trustees, guardians, and administrators). *See* INVESTMENT CO. INST., *supra* note 4, at 95.

investors creating redemption problems.¹⁵³ The parent fund, like any other institutional investor, has some incentive not to redeem en masse if doing so might force distress selling by its portfolio fund. This is because the investing fund would usually suffer pro rata in any diminution in value experienced by the portfolio fund.

Second, the proponents of the antipyramiding provision failed to cite any evidence that redemption pressures of the severity needed to cause the harms envisaged in the Act's legislative history are likely or even reasonably possible. Even during major market drops, fund redemptions have remained quite low.¹⁵⁴ When combined with the relative performance-insensitivity of fund shareholders¹⁵⁵ and the liquidity requirements and other protections discussed above,¹⁵⁶ the likelihood that redemptions could harm minority shareholders seems low.

The fears that a foreign fund is especially likely to put redemption pressure on U.S. funds it owns seem equally questionable. Section 12(d)(1) singles out foreign funds for special restrictions, by making them ineligible for subparagraph 12(d)(1)(F)'s exemption from 12(d)(1)(A)(ii)-(iii) restrictions (i.e., a foreign fund may in no case invest more than five percent of its assets in a single U.S. fund or more than ten percent in all U.S. funds).¹⁵⁷ Yet little evidence exists that foreign funds would not be dissuaded from making massive, rapid redemptions by the market considerations discussed above or that their investment behavior has in fact been more volatile than that of U.S.

¹⁵³ See Hub-and-Spoke Report, *supra* note 124, at 9.

¹⁵⁴ The largest net outflow of fund assets during the 1944 to 1995 period was in response to the October 1987 market drop. See INVESTMENT CO. INST., *MUTUAL FUND FACT BOOK* 45 (37th ed. 1997). During the weeks following the crash, 4.5% of total equity fund assets were liquidated, but only 5% of shareholders redeemed during this time. See *id.* During the eight other stock market declines from 1977 through 1990, the largest one-month outflow from stock funds was 1.1% of total stock assets. See *id.*; see also Carole Gould, *Will the Dominoes Fall?*, N.Y. TIMES, July 27, 1997, § 3, at 9 (noting that the Federal Reserve Bank of New York Economic Policy Review Study concludes that a 1% stock market drop is likely to result in redemption of less than 0.1% of mutual fund assets).

An individual fund might experience outflows greater than the low industry-wide figures. Yet historical examples of redemption-induced panics that harmed shareholders are hard to find. In addition, a fund holding company may be less susceptible to market volatility because its portfolio would be more diversified than those of its portfolio funds. See *supra* note 181; cf. Vanguard STAR Fund et al., *supra* note 66, at 50,659 (noting that a parent fund experienced a substantially lower redemption rate than portfolio funds).

¹⁵⁵ See *supra* text accompanying notes 25-34.

¹⁵⁶ See *supra* notes 139-44.

¹⁵⁷ By its terms, § 12(d)(1)(F) is available only for registered investment companies. See Investment Company Act of 1940, 15 U.S.C.A. § 80a-12(d)(1)(F) (West 1997).

institutions or foreign institutions other than investment companies. Given the substantial and growing volume and the diversification benefits of cross-border investing,¹⁵⁸ there is little basis on which to single out mutual funds as a financial institution that should, or can, be insulated from the effects of foreign market developments.¹⁵⁹

Finally, even assuming that the worst fears of its proponents were valid, the antipyramiding provision is overly broad in several ways.¹⁶⁰ Section 12(d)(1) applies to investments by open-end funds of closed-end funds as well as to investments by closed-end funds in open-end companies. Yet since closed-end fund shares are not redeemable, none of the redemption scenarios feared by the proponents of the antipyramiding provision could exist in the former situation.¹⁶¹ In the latter situation, it is of course possible for a closed-end fund to redeem its shares in an open-end fund. But because the closed-end fund is itself not obligated to redeem its shares, the special fear envisaged in the *PPI Report* (a domino effect started by redemptions at the parent level) cannot occur.

The antipyramiding provision is also overly broad in its coverage of investments by registered funds in foreign funds because the United States lacks an interest in protecting minority shareholders in such funds from the effects of redemption pressures. In addition, the five and ten percent restrictions in subsections 12(d)(1)(A)(ii)–(iii) are also not necessary to protect against redemption pressures.

The five and ten percent restrictions do somewhat reduce the chance that an acquiring fund will be forced to redeem its shares in the portfolio fund, as these restrictions ensure that the acquiring fund will have plenty of assets (other than

¹⁵⁸ See, e.g., Request for Comments, *supra* note 40, at 25,324 (stating that in 1989, 193 U.S. investment companies “with total assets of about \$27 billion” “invest[ed] primarily in foreign securities”; “50 other open-end companies had at least 25% of their portfolios invested in securities traded outside of the United States, with total assets of about \$15.1 billion”); Christopher G. Bernard, Note, *Towards an International Market in Mutual Funds*, 36 VA. J. INT’L L. 467, 469 n.7 (1996) (observing that in 1994, 657 foreign companies from 43 countries had shares listed on a U.S. exchange or NASDAQ).

¹⁵⁹ See ROGER G. IBBOTSON & GARY P. BRINSON, *GLOBAL INVESTING: THE PROFESSIONAL’S GUIDE TO THE WORLD CAPITAL MARKETS* 145–48 (1993) (correlation of worldwide equity returns). *But cf.* *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 987–88 (2d Cir. 1975) (discussing plaintiffs’ argument that the collapse of Fund of Funds caused an adverse economic effect on U.S. securities markets and on American investors). See generally Bernard, *supra* note 158 (proposing international standards for mutual fund regulation).

¹⁶⁰ Of course, some of these restrictions may be justified as furthering the provision’s other goals, such as breaking up concentrations of financial power.

¹⁶¹ Because of this, the liquidity requirements do not apply to closed-end funds.

fund shares) to sell if necessary. However, the three percent limit in section 12(d)(1)(F)(i) seems adequate to address redemption concerns because even if the acquiring fund was forced to sell all its assets, the target fund would experience only a three percent redemption, a tolerable level that is within the historic range.

B. *Excessive Concentration of Financial Power*

As discussed above,¹⁶² although Congress and the SEC were concerned about the conflicts of interest and other harms that may arise due to the threat of redemption by a parent fund, they had a separate concern about the concentration of power that fund holding companies represented. In this respect, the antipyrarniding provision is one of several applications of the nation's traditional populist suspicion of financial power per se. This suspicion is expressed (among other places in the Act) in section 12(d)(1)(F), which permits a fund to invest more than five percent of its assets in a single fund or more than ten percent of its assets in all funds combined only if it votes its shares either in the same proportion as other holders of the portfolio fund or as directed by the parent fund's shareholders, after seeking their instructions.¹⁶³ In either case, the manager of the holding company has no voting control over the portfolio fund.

Once again, section 12(d)(1) seems poorly designed to achieve Congress's stated goals. First, the Act seems to take an overly cautious view of control. In other contexts, Congress concluded that intercorporate control does not exist until significantly higher cross-ownership exists. The Act itself, for example, presumes that a person does not control a company if the person owns less than twenty-five percent of the company's stock.¹⁶⁴ In its regulation of takeovers of noninvestment companies under the Securities Exchange Act of 1934, Congress chose not to even require disclosure of corporate investments until they reached the five percent level.¹⁶⁵ In the insider trading arena, only ten percent

¹⁶² See *supra* text accompanying notes 73–76.

¹⁶³ See Investment Company Act of 1940, 15 U.S.C.A. §§ 80a-12(d)(1)(A)(I)–(II), 12(d)(1)(F), 12(d)(1)(E)(iii)(aa) (West 1997). Use of the former option is more likely since the latter one—seeking voting instructions from the parent's investors—would require the parent fund to arrange with the portfolio fund's management to obtain proxy solicitation material so that the parent fund can pass it along to its shareholders in time to obtain their instructions.

¹⁶⁴ See *id.* 15 U.S.C. § 80a-2(a)(9) (1994). The Act's "control" definition is relevant, e.g., to its definitions of "affiliated person," see *id.* § 80a-2(a)(3), and its coverage of investment companies acting through subsidiaries, see *id.* § 80a-7.

¹⁶⁵ See Securities Exchange Act of 1934, 15 U.S.C. § 78m(d) (1994).

stockholders are presumed to have control.¹⁶⁶

Moreover, smaller funds would be unable to acquire even three percent of another fund because of the five and ten percent restrictions in section 12(d)(1)(A)(ii)–(iii).¹⁶⁷ Although section 12(d)(1)(F) offers an exemption from the five and ten percent restrictions, many funds would find this exemption impractical because the conditions in section 12(d)(1)(F)(i)–(ii) may conflict with the acquiring fund's obligation under section 22(e) of the Act to promptly redeem its securities on demand. The five and ten percent restrictions are thus difficult to justify from the viewpoint of preventing concentrated financial control (because their only relevance is to reduce the permitted interfund acquisition below three percent).¹⁶⁸

In addition, the antipyrarniding provision is based on the assumption that a holding company that acquired a significant stake in a fund could seize control from that fund's shareholders. Yet it is widely acknowledged that, even more so than in the context of public corporations, a fund's shareholders do not control it—the adviser does.¹⁶⁹ If any entity is to control a fund, a holding company investor (which is, after all, a part owner of the fund) seems a better choice than the manager, which often has no ownership interest in the fund and faces extensive conflicts of interest in the operation of the fund.

As a related matter, despite its goal of constraining financial power, the antipyrarniding provision does nothing to address the power of the companies that sponsor and manage mutual funds. While Congress has long been concerned with the harmful effects that might arise from the excessive size of funds, it has not considered whether the same harms might arise from the growth of fund complexes and the resulting ability of a single advisory company to control the assets of all the funds in that group.¹⁷⁰ In fact, power in

¹⁶⁶ See *id.* § 78p(a) (identifying 10% stockholders as "principal stockholders"); Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, Securities Exchange Act Release No. 28,869, Public Utility Holding Company Act Release No. 25,254, Investment Company Act Release No. 17,991, 56 Fed. Reg. 7242, 7244 (1991) (to be codified at 17 C.F.R. pts. 229, 240, 249, 270, and 274) (noting that 10% stockholders are "presumed to have access to inside information because they can influence or control the issuer as a result of their equity ownership"); see also William M. Isaac & Melanie L. Fein, *Facing the Future—Life Without Glass-Steagall*, 37 CATH. U. L. REV. 281, 335–36 app. (1988) (bank holding companies may acquire up to 5% of the voting securities and up to 24.9% of the equity of non-banking-related companies).

¹⁶⁷ A fund trying to invest in a larger fund could reach the 5 and 10% restrictions before it acquired 3% of the target fund.

¹⁶⁸ These restrictions are also not justifiable from the viewpoint of avoiding redemption pressures. See *supra* text accompanying notes 152–59.

¹⁶⁹ See *supra* text accompanying note 190–94.

¹⁷⁰ All funds in a fund group or complex are organized and distributed by a single

the advisory business is more concentrated than it is among individual funds. Concentration in the investment management business is increasing.¹⁷¹ Given the adviser's unchallenged authority over each fund it advises, the harms perceived from concentrated financial power at the fund complex level seem no less worrisome than those at the fund level.¹⁷² Yet the "master-feeder" and "hub-and-spoke" liberalizations allowed by Congress and the SEC in recent years facilitate growth of fund complexes.

C. Layering of Fees

As discussed above, a major basis for Congress's enactment of section 12(d)(1) was a concern that the holding company structure led to higher total costs to shareholders of the holding company because of "layering of fees."¹⁷³ Yet section 12(d)(1) appears to be a flawed weapon for combating this problem, for several reasons.

First, section 12(d)(1) is overly broad with respect to cost-layering because of the way it treats foreign funds. Foreign funds are excepted from almost all of the Act's registration and substantive requirements¹⁷⁴ because of the lack of a U.S. interest in protecting their investors, who generally are not U.S. residents. The concern about excessive fees applies only to shareholders of the holding company, since no "layering" affects public shareholders of a lower-tier fund. The "cost layering" theory, then, provides no policy reason to apply section

sponsor. The funds also share a common adviser, which in practice is selected by the sponsor. See Rock, *supra* note 28, at 1604.

¹⁷¹ See Michael Quint, *More Consolidations in Mutual Funds*, N.Y. TIMES, Aug. 25, 1994, at D3; Peter Truell, *Insurer Is Said to Near a Deal for Scudder*, N.Y. TIMES, May 30, 1997, at D1 (noting that a study predicts about 20 companies each with more than \$150 billion in assets will dominate the advisory business by the year 2000); see also BAUMOL ET AL., *supra* note 7, at 26 (the number of funds per complex increased from four to six during 1982 to 1987).

¹⁷² In certain respects, a fund family is subject to the same limitations as a single fund. All funds managed by the same adviser are probably affiliates for purposes of section 12(d)(1), and thus their holdings must be aggregated when determining compliance with the 3% limit. See FundTrust, *supra* note 46, at *3. In addition, holdings of funds in a family may also be aggregated for purposes of determining compliance with the Act's diversification requirement, which prevents funds calling themselves diversified from owning more than 10% of an operating company. See Investment Company Act of 1940, 15 U.S.C. § 80a-5(b)(1) (1994); see also Roe, *Political Elements*, *supra* note 74, at 1477.

¹⁷³ See *supra* text accompanying notes 82-84.

¹⁷⁴ See DIVISION OF INV. MANAGEMENT, SECURITIES & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 105-14 (1992) [hereinafter "PROTECTING INVESTORS"] (discussing exceptions for private investment companies and qualified purchasers).

12(d)(1) to foreign investment companies.

Second, layering of costs occurs in other legally permissible contexts. These include accounts managed by investment advisers¹⁷⁵ and funds managed by bank trust departments.¹⁷⁶ Both such accounts may invest client funds in mutual funds, leading to "layered" costs because of the existence of fees charged by the portfolio funds and by the adviser or trust department.

Third, Congress and the SEC have concluded that a fund holding company whose portfolio funds are wholly owned (i.e., a master-feeder fund or a hub-and-spoke fund) may have lower costs than a free-standing fund.¹⁷⁷ As noted above, the basis for this belief is that such a fund could reduce its operating costs while improving services delivered to shareholders, because, e.g., funds in a holding company may share research and investment management services.¹⁷⁸ In addition, Congress and the SEC have accepted the argument that fund holding companies may achieve greater diversification than individual

¹⁷⁵ The SEC has, for example, allowed a Fidelity affiliate to charge a fee of up to 1% of assets for a service that invested, on a discretionary basis, clients' money in other Fidelity funds. The portfolio funds charged annual fees and sales loads up to 3%. *See* Fidelity Managed Accounts, SEC No-Action Letter, Dec. 13, 1988, *available in* LEXIS, FedSec Library, NoAct File, 1988 SEC No-Act. LEXIS 1641, at *7.

¹⁷⁶ *See* 3 FRANKEL, *supra* note 42, § 7.1, at 32.

¹⁷⁷ *See* Vanguard STAR Fund, *supra* note 66, at 50,659 (contending a fund holding company would reduce "account maintenance costs, because an investor will not need to maintain two or more accounts to attain a desired allocation"; such funds produce lower expense ratios because of "a new STAR Fund Portfolio's ability to take advantage of the existing asset base created by the acquired Funds"; "the resulting addition of assets to The Vanguard Group produces cost savings and other benefits for all Funds even if they are not the acquired Funds").

¹⁷⁸ *See, e.g.*, 141 CONG. REC. E868 (daily ed. Apr. 7, 1995) (statement of Rep. Fields) (remarks of Rep. Fields, sponsor of bill that became the 1996 amendment, supporting fund-of-fund relaxation because it would enable "professional money managers" to "benefit, on behalf of the investors in their mutual fund, from the expertise of other professionals in investments with which they themselves may not be familiar"; this advantage is especially important because of the growing need of U.S. managers to invest their clients' money in foreign markets with which they have less familiarity); Brinson Relationship Funds et al., *supra* note 150, at 48,517 (holding company structure facilitates following "a large number of issuers . . . [by] exploit[ing] the expertise of [specialized] portfolio managers"); FundTrust, *supra* note 46, at *21 (Investors in a fund investing in unaffiliated open-end funds would benefit from "efficient professional selection and monitoring of the large number and bewildering variety of mutual funds."); Hub-and-Spoke Report, *supra* note 124 (reduced costs due to "economies of scale by sharing . . . fixed expenses of portfolio management[,] . . . fund administration [and] . . . securities transactions"); Vanguard Special Tax-Advantaged Retirement Fund, Inc., Investment Company Act Release No. 14,361, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,737 (Feb. 7, 1985); Gruber, *supra* note 13, at 783.

funds, both by increasing the number of underlying stocks held and by owning funds with differing investment styles.¹⁷⁹ Although the SEC has accepted these arguments only in the context of funds within a given "family" (and dismissed them regarding fund holding companies owning less than one-hundred percent of their portfolio funds¹⁸⁰), theoretical reasons exist to think the conclusion less valid in the latter context—and some evidence shows that such benefits result from interfund investments outside fund families.¹⁸¹ If true, these conclusions suggest that fund holding companies could offer their shareholders less volatile returns at lower costs than funds prevented from investing in other funds above the section 12(d)(1) limits. The fact that at least some fund sponsors desire to participate in such funds¹⁸² suggests that they might offer investors a risk-reward package at an attractive cost.¹⁸³

In any event, as shown above, neither section 12(d)(1) nor any of the other statutory and regulatory steps taken to address high costs¹⁸⁴ have reduced fund

¹⁷⁹ See Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1, 18–20 (1997) (espousing diversification of stock as a method needed to eliminate firm-specific risk).

¹⁸⁰ See PPI REPORT, H.R. REP. NO. 89-2337, at 320 (1966) ("[D]iversification upon diversification does not result in greater safety in proportion to the number of layers imposed on the original investment.").

¹⁸¹ See 141 CONG. REC. E868 (daily ed. Apr. 7, 1995) (statement of Rep. Fields); Vanguard Special Tax-Advantaged Retirement Fund, Inc., *supra* note 178; Hub-and-Spoke Report, *supra* note 124; Wang, *supra* note 1, at 1043–45; Francis Flaherty, *Multifunds: Diversified to a Fare-Thee-Well*, N.Y. TIMES, Dec. 25, 1993, § 1, at 45; Kara Fitzsimmons, *Owning Closed End Funds—Unwittingly*, WALL ST. J., May 8, 1997, at C23 (open-end funds buy closed-ends because they are perceived as good investments); *Fund of Funds Loses a Round*, *supra* note 112, at 61; Yee, *supra* note 112, at 71.

¹⁸² See, e.g., American Pension Investors Trust, SEC No-Action Letter, Feb. 1, 1991, available in LEXIS, FedSec Library, NoAct File, 1991 SEC No-Act. LEXIS 279 (open-end fund investing in 10 to 35 unaffiliated open-end funds); Bodipo-Memba, *supra* note 124, at C1; Phalon, *supra* note 100, at 63 (before the 1970 amendments, two funds not affiliated with Fund of Funds registered as fund holding companies).

¹⁸³ The possibility that a fund holding company might make other changes in the operation of its portfolio funds by means of changes imposed through the corporate governance process, see *infra* text accompanying notes 230–31, would offer another way to reduce costs for shareholders.

¹⁸⁴ See Disclosure of Mutual Fund Performance and Portfolio Managers, Securities Act Release No. 6988, Investment Company Act Release No. 19,382, 58 Fed. Reg. 19,050, 19,050 (1993) (to be codified at 17 C.F.R. pts. 239, 270, and 274) (requiring fund prospectuses or annual reports to compare fund performance to index and provide investors with information showing performance on per share basis); Consolidated Disclosure of Mutual Fund Expenses, Securities Act Release No. 6752, Investment Company Act Release No. 16,244, 53 Fed. Reg. 3192, 3192 (1988) (to be codified at 17 C.F.R. pts. 239 and 274).

fees, which are significantly higher than they were at the time of adoption of the 1970 amendments that tightened section 12(d)(1).

D. *Undue Organizational Complexities*

The concern with organizational complexity is that it might be difficult for an unsophisticated shareholder to appraise the true value of his investment due to the complexity of a holding company's structure.¹⁸⁵ This concern does not explain the application of section 12(d)(1) to acquisitions by foreign holding companies because Congress had no interest in protecting foreign investors from such complexities.¹⁸⁶ With respect to domestic funds, a fund holding company seems no more complex than many interlocked corporate structures. Indeed, the ability to calculate the net asset value of each fund in a holding company seemingly makes it easier for an investor to evaluate her holding than it would if she owned shares in a corporation with complex cross-ownership.

V. EFFECTS OF THE ANTIPYRAMIDING PROVISION: THE ABSENCE OF AN EFFECTIVE MANAGERIAL MONITOR

Fund managers are agents of the fund's shareholders. As it does in noninvestment company corporations, the separation of management and ownership in funds gives rise to a host of problems that have been explored by scholars.¹⁸⁷ This Article suggests that the antipyramiding rule exacerbates these problems in the mutual fund arena.

Professor Black has identified several categories of possible constraints on corporate managers.¹⁸⁸ These include shareholder monitoring via the corporate governance process, the corporate control market, the product market, the capital market, incentive compensation arrangements, creditor monitoring, the

(fee table required in mutual fund prospectuses); Anand, *supra* note 13.

¹⁸⁵ See *Hearings*, *supra* note 77, at 238-39 (statement of David Schenker); 86 CONG. REC. S2844-47 (Mar. 14, 1940) (statement of Sen. Wagner).

¹⁸⁶ See *The Phoenix Funds*, *supra* note 66, at *5 (foreign banks to buy shares of a U.S. fund on the condition that the nature of investment would be adequately disclosed to non-U.S. investors).

¹⁸⁷ See, e.g., Coffee, *supra* note 144, at 1284; Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 347-65 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453-63 (1991); Roe, *Political Theory*, *supra* note 73, at 54 (citing studies); Manuel A. Utset, *Disciplining Managers: Shareholder Cooperation in the Shadow of Shareholder Competition*, 44 EMORY L.J. 71, 86-92 (1995).

¹⁸⁸ See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 887 (1992).

risk of bankruptcy if a company cannot service its debt, fiduciary duties, and cultural norms of behavior. The following discussion examines certain of these types of restraints in light of the antipyramiding rule.

A. Shareholder Monitoring via Governance Process

One way shareholders may monitor and control their fund's manager is through the corporate governance process. However, though shareholder approval is required for many fund actions,¹⁸⁹ in practice shareholders routinely approve management proposals.¹⁹⁰ Even the SEC has concluded that shareholder voting is "often a 'ritualistic anachronism'" for mutual funds, noting that funds often find it difficult to obtain a quorum, meeting attendance is generally sparse, and votes are almost always supporting the adviser's wishes.¹⁹¹ The paucity of shareholder activism is noteworthy even in comparison to corporations other than funds, in which significant difficulties with managerial monitoring have been identified.¹⁹²

¹⁸⁹ See, e.g., Investment Company Act of 1940, 15 U.S.C. § 80a-15(a) (1994); *id.* § 80a-15(a)(2)-(b)(1) (shareholders or board must approve certain advisory and underwriting contracts); *id.* § 80a-15(a)(3)-(4) (shareholders must approve new management contract after termination or assignments of the contract, and approve changes to the management contract); *id.* § 80a-13(a) (changing funds' fundamental investment policies requires a vote of shareholders); Rules and Regulations, Investment Company Act of 1940, 17 C.F.R. § 270.12b-1(b)(1) (1997) (management contracts must be approved by shareholders initially). See generally 3 HAZEN, *supra* note 42, § 17.6; Richard M. Phillips, *Deregulation Under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903 (1982); Wang, *supra* note 1.

¹⁹⁰ See, e.g., WHARTON STUDY, H.R. REP. NO. 87-2274, pt. 1, at 67 (1962) ("[O]pen-end investment companies are typically legal shells without genuine autonomy, controlled by external management interests."); Phillips, *supra* note 189, at 908-09 & n.13; Wang, *supra* note 1, at 1005-08; Simon, *How Funds Get Rich*, *supra* note 21, at 131 (shareholders approved request by closed-end stock fund to increase its fees 31%, taking its profit margin from 84% to 88%; shareholders approved 17% fee raise for a fund that already had after-tax profits of 37%).

¹⁹¹ PROTECTING INVESTORS, *supra* note 174, at 272-76 (funds often cannot obtain a quorum at shareholder meetings, and vote outcomes are almost never contrary to the wishes of the adviser); see also *Galfand v. Chestnut Corp.*, 545 F.2d 807, 808 (2d Cir. 1976) ("The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects its portfolio and administers its daily business."); Request for Comments, *supra* note 40, at 25,327 ("assumption that, in the open-end management investment company context, voting shareholders and directors are 'redundant'").

¹⁹² See Rock, *supra* note 187, at 450-51.

The same is generally true of funds' board of directors, which despite requirements of independence have generally been viewed as displaying little independence from the fund's adviser, because they are appointed by the adviser and dependent on the adviser for continued tenure and information.¹⁹³ Although the board of directors sometimes negotiates fee rates below that proposed by the adviser, the amount of the reduction is usually marginal.¹⁹⁴ Weaknesses in the fund governance process led the SEC to propose an alternative fund form that would eliminate shareholder governance altogether.¹⁹⁵

It is possible that, by eliminating funds as significant investors in other funds, the antipyramiding rule has contributed to the fragmentation of mutual fund ownership.¹⁹⁶ Indeed, this was one of the Act's stated goals.¹⁹⁷ Small funds acquiring large funds may in effect be prevented even from reaching the three percent level allowed by section 12(d)(1) by the five and ten percent limits in section 12(d)(1)(A).¹⁹⁸

Theory predicts that when stock ownership is fragmented, management's power will increase at the expense of shareholders due to collective action problems. Evidence exists that the absence of large shareholders, who might profitably undertake the function of monitoring the fund manager, has contributed to the dominance of the manager over shareholders and to the high

¹⁹³ See PPI REPORT, H.R. REP. NO. 89-2337, at 10-12, 102-21, 126-27 (1966); WHARTON STUDY, H.R. REP. NO. 87-2274, at 30-34, 66-67; Advanced Notice and Request for Comment on Mutual Fund Governance, Investment Company Act Release No. 12,888, 47 Fed. Reg. 56,509, 56,510, 56,511 (1982); PROTECTING INVESTORS, *supra* note 174, at 255-66; Tamar Frankel & Wayne M. Barsky, *The Power Struggle Between Shareholders and Directors: The Demand Requirement in Derivative Suits*, 12 HOFSTRA L. REV. 39, 58-59, 64 (1983); Phillips, *supra* note 189, at 910-11; Wang, *supra* note 1, at 983; John A. Otoshi, Note, *Class Action Treatment of Shareholders' Suits Under Section 36(b) of the Investment Company Act*, 83 COLUM. L. REV. 2039, 2041-42 (1983); *Tri-Continental Directors Turn Deaf Ear on Wake Up Call*, N.Y. TIMES, May 18, 1997, Bus. Sec., at 7 (publisher of *Morningstar Mutual Funds* states that boards "just rubber-stamp management's plans"); cf. *Ex-Fund Manager Blocks Trustees' Actions*, N.Y. TIMES, June 17, 1997, at C2.

¹⁹⁴ See Wang, *supra* note 1, at 990.

¹⁹⁵ See Request for Comments, *supra* note 40, at 25,326-27.

¹⁹⁶ Individuals own about 74% of all mutual funds and about 60% of all equity and bond funds. See INVESTMENT CO. INST., *supra* note 154, at 35; see also WHARTON STUDY, H.R. REP. NO. 87-2274, pt. 1, at 64; *Survey Finds Small Investors Held On to Stocks in Slump*, WASH. POST, Apr. 16, 1994, at D1.

¹⁹⁷ See *supra* note 88.

¹⁹⁸ The conditions imposed by the section 12(d)(1)(F) exemption limit that provision's utility as a means of escaping the 5 and 10% caps.

level of fees fund shareholders pay.¹⁹⁹ Funds suffer from agency problems that appear to be at least as great as those afflicting corporations.²⁰⁰ Of course, other institutions, whose investments are not impeded by the antipyramiding rule, could have taken large stakes in funds and overcome collective action problems. At a minimum, though, the provision has eliminated one significant large investor from the corporate governance arena.

B. Corporate Control Market

Sections 12(d)(1) and 17 have effectively eliminated other funds as potential acquirers of mutual funds. The private right of action available under section 12(d)(1) provides funds with a weapon against hostile investments in excess of section 12(d)(1)'s strict limits.²⁰¹

A critical question, though, is why other entities have not acquired funds. If hostile fund takeovers or proxy battles presented profitable investment opportunities, one would expect others to take advantage of them. Potential acquirers would include wealthy individuals, banks, and pension funds.

A number of obstacles would face such acquirers. Wealthy individuals could not act through private investment funds because, as a result of the 1996 amendment to the Act, the antipyramiding provision now applies to such funds

¹⁹⁹ See WHARTON STUDY, H.R. REP. NO. 87-2274, pt. 1, at 64, 67 (shareholder voting rights have "limited value" because of wide diffusion of share ownership); *id.* at 30 (conflict of interest inherent in fund governance structure led to levels of adviser compensation greater than what would result from arm's length bargaining); Coffee, *supra* note 144, at 1283 n.21, 1335-36; Rock, *supra* note 187, at 452 (increasing concentration of shareholding raises problems of increased agency costs within the institutions); Wang, *supra* note 1, at 1006; *see also* PPI REPORT, H.R. REP. NO. 89-2337, at 12-13 (1966); Otoshi, *supra* note 193, at 2039; Simon, *How Funds Get Rich*, *supra* note 21, at 132-33 (lower expense ratios for management of institutions' funds are attributable to their greater bargaining power).

Large shareholdings are correlated with higher returns for corporations. *See* Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 917-24 (1992); Gilson & Kraakman, *supra* note 71, at 1006-08.

²⁰⁰ *See* Black, *supra* note 188, at 814-15; Coffee, *supra* note 144, at 1283, 1335-36; Gilson & Kraakman, *supra* note 71, at 985-86; Rock, *supra* note 187, at 452.

²⁰¹ *See, e.g.,* Bancroft Convertible Fund, Inc. v. Zico Investment Holdings, Inc., 825 F.2d 731 (3d Cir. 1987) (holding that the Investment Company Act had an implied right of private action in enforcing the antipyramiding provision and defining a tender offeror as an investment company); Clemente Global Growth Fund, Inc. v. Pickens, 729 F. Supp. 1439 (S.D.N.Y. 1990) (holding that genuine issues exist as to whether successor's tender-offer vehicle was an investment company); Clemente Global Growth Fund, Inc. v. Pickens, 705 F. Supp. 958, 963 (S.D.N.Y. 1989).

As to whether hostile acquisitions of mutual funds would be possible in the absence of these legal restrictions, *see infra* Part VI.

(despite their exemption from the definition of investment company).²⁰² Although individuals are exempt from the antipyridding provision by virtue of the fact that they do not come within the investment company definition, a group of individuals operating together in a coordinated fashion are likely to be viewed as an investment company and thus subjected to the antipyridding provision.²⁰³ Therefore, only wealthy individuals acting alone could avoid the antipyridding provision.

A corporation could be the acquirer, but only if it avoided classification as an investment company by keeping its investment (combined with other securities it owned) below forty percent of its assets and did not engage "primarily" in making such acquisitions and other securities investing or trading. The uncertainty associated with the latter requirement and the high costs of classification as an investment company might deter corporations from taking this step.

Banks' ability to invest in mutual funds is limited. National and state Federal Reserve System member banks may not invest for their own account in stock mutual funds (though purchase of shares of investment-grade bond funds is permissible).²⁰⁴ However, financial constraints limit banks' ability to make use of their power to buy both bond and equity mutual funds.²⁰⁵ In addition, some banks' interests in providing custodial and other services to funds may dissuade banks from taking public, hostile roles against funds.²⁰⁶ Similar conflicts might afflict small money managers who hope to sell research to funds or their broker-dealer affiliates.²⁰⁷

Nonscientific observation suggests that the legal and practical barriers facing nonfund acquirers are high. In the few takeovers of U.S. closed-end

²⁰² Private investment funds are exempt from the Act under §§ 3(c)(1) (funds with fewer than 100 investors) and 3(c)(7) (funds all of whose investors are sophisticated). *See generally* Steven Boehm, *Hedge Funds and Other Collective Investment Vehicles*, 30 REV. SEC. REG. & COMMODITIES REG. 35 (1997) (discussing the impact of §§ 3(c)(1) and (c)(7)).

²⁰³ *See* Investment Company Act of 1940, 54 Stat. 789, 791 (1940) (current version codified at 15 U.S.C.A. § 80a-2(a)(8) (West 1997)) ("investment company" includes "any organized group of persons whether incorporated or not"); *see also* Bancroft Convertible Fund, Inc., 825 F.2d at 736-38; Clemente Global Growth Fund, Inc., 705 F. Supp. at 963-65.

²⁰⁴ *See* Isaac & Fein, *supra* note 166, at 335-36 app. Bank holding companies' power to acquire fund shares is also limited. *See id.*

²⁰⁵ *See* Coffee, *supra* note 144, at 1319-20.

²⁰⁶ *Cf.* Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1028 (1994); Roe, *Political Elements*, *supra* note 74, at 1503.

²⁰⁷ *See* Roger M. Klein, *Straining to Uncork Value in a Closed-End Fund*, N.Y. TIMES, Apr. 23, 1995, § 3, at 8 (small money manager's unwillingness to state publicly it would vote against management in fund proxy battle).

funds that have occurred, the acquirers were wealthy individuals and private investment funds²⁰⁸—not banks or other institutional investors.²⁰⁹ Outside the United States, the acquirers of funds have often been other funds.²¹⁰

It is possible that non-legal factors reduce the economic appeal of funds as an acquisition target for institutions other than funds. A decision by an acquirer to invest in a fund in the hope of improving its performance must depend on a balancing of the anticipated costs of monitoring activities against the benefits to be derived from a change in the fund's policies. This investment opportunity must then be compared to other investment opportunities available to the potential acquirer. It may be that only another fund can realize enough of the advantages of a fund acquisition to make it worthwhile. This seems a realistic possibility, since many of these advantages would arise from the economies that only another fund could realize.²¹¹ In addition, funds are ideally suited to be active shareholders of other funds: fund acquirers possess a higher degree of expertise in fund management (e.g., evaluating fund performance and operating methods) than do other possible acquirers.²¹²

²⁰⁸ These individuals and private investment funds were at the time exempt from the antipyridding provision. See *supra* note 202 and accompanying text.

²⁰⁹ See, e.g., ALFRED FREDMAN & GEORGE SCOTT, *INVESTING IN CLOSED-END FUNDS: FINDING VALUE AND BUILDING WEALTH* 381-86 (1991); Susan Antilla, *Raiders Lick Their Chops Over Closed-End Funds*, USA TODAY, Mar. 1, 1989, at B3; Floyd Norris, *A Crucial Vote at Cypress Fund*, N.Y. TIMES, Dec. 14, 1989, at D12; *Sequoia Partners Denounces Counselors Tandem Fund's Poor Performance*, PR Newswire, Mar. 23, 1990, available in LEXIS, Nexis Library, Arcnws File; see also Klein, *supra* note 207, at 8 (bank trust department has a practice of voting for management in proxy battle). But see Nicholas Denton, *Malaysia Fund to Go Open-Ended*, FIN. TIMES (London), July 19, 1996, at 18 (fund converts to open-end form in response to demands of shareholders, including pension fund).

²¹⁰ See, e.g., Nick Gardner, *Kleinwort Plans Trust Switch*, SUNDAY TIMES (London), Aug. 4, 1996, § 6, at 1 (manager will "open-end" trust to avoid hostile takeover bid by another investment trust); *Regent Confident on GT Chile Fund Takeover*, INT'L MONEY MARKETING, Aug. 18, 1995, available in LEXIS, Nexis Library, Arcnws File (fund organized to make hostile acquisitions of closed-end funds in Czech Republic); Michael R. Sesit, *London Fund,irate Suitor Pose Wider Worry*, WALL ST. J., Feb. 7, 1996, at C1 (hostile takeover of GT Chile Growth Fund by fund manager); Nikki Tait, *Throgmorton Bid Wins Framlington*, FIN. TIMES (London), Apr. 30, 1988, Weekend Supplement, at IV; Shiv Taneja, *Regent Pacific Trust Buys Assets of Thornton Asian*, BUS. TIMES, June 7, 1996, at 18 (U.K. investment trust acquired another such trust by tender offer); Roger Taylor, *Aggressive Instincts Threaten the Quiet Life*, FIN. TIMES (London), Sept. 23-24, 1995, Weekend Money Sec., at 2 (describing takeovers of U.K. trusts by other trusts as a way that the investment industry is trying to expand again).

²¹¹ See *supra* note 13.

²¹² Cf. Smith, *supra* note 179, at 28-29 (relying primarily on Black, *supra* note 188, at 834-35).

C. Incentive Compensation Arrangements

Financial incentives are another way to align the interests of shareholders and managers and thereby reduce agency costs.²¹³ The typical investment fund advisory contract partially accomplishes this because fees are based on a percentage of assets under management and better performance tends to attract additional assets.²¹⁴ But to the extent fund outflow and inflow do not correlate to performance,²¹⁵ this alignment is imperfect. Moreover, from their position as insiders, managers can derive opportunities to engage in personal investment activities that can conflict with shareholders' interests.²¹⁶

Compensation schemes that would improve the alignment could be devised: the adviser's compensation could be tied directly to performance.²¹⁷ The adviser (and fund directors) could be paid in shares of the fund. Yet statutory and regulatory barriers make these techniques difficult for funds to employ,²¹⁸ and it appears neither is widely used.²¹⁹

D. Creditor Control

Monitoring of fund managers cannot be conducted, as it is in some national

²¹³ Agency costs can be viewed as the costs of those actions, including monitoring and "bonding," that investors must take to police conflicts between the interests of the adviser and investors. See Black, *supra* note 188, at 882-85; Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 595-96 (1990); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2040 (1994); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Wang, *supra* note 1, at 974-75.

²¹⁴ See Wang, *supra* note 1, at 975.

²¹⁵ See *id.*

²¹⁶ See generally Rock, *supra* note 28, at 1614-26.

²¹⁷ Studies have found that corporate performance is positively correlated with the proportion of equity owned by management. See Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 821 (1993).

²¹⁸ Fund managers may not be compensated with equity or long-term options. See Investment Company Act of 1940, 15 U.S.C. §§ 80a-18(d), 23(a) (1994); Gilson & Kraakman, *supra* note 71, at 999. Tying payments under the advisory contract to fund performance is difficult. See Coffee, *supra* note 144, at 1364; John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 866-67 (1994).

²¹⁹ Independent directors of funds are generally paid annual cash fees, rather than shares of stock or other performance-based compensation. See Wang, *supra* note 1, at 974.

systems,²²⁰ by banks because funds' ability to borrow is strictly limited.²²¹

E. Redemption

The redemption right gives investors a low-cost means of exiting a fund. Redemption by a fund investor hurts the manager much more than sale by a holder of corporate stock hurts corporate officers. The latter sale merely results in a change of stockholders, whereas a fund redemption reduces the assets under management, directly reducing the manager's income.²²² The ease with which investors can evaluate fund management and compare the performance of different funds (due to the daily computation of net asset value and the many publications that rate and compare funds) reduces search costs for the exit decision. Additionally, the absence of brokerage commissions and the existence of telephone redemption methods lower the transaction costs of exit. The threat of redemption could therefore serve as a powerful constraint on management. It has been suggested that the adequacy of this exit threat has eliminated investors' need for any other means of monitoring managers.²²³

Yet, there is some reason to question whether the redemption right adequately constrains fund managers.²²⁴ The fact that redemptions do not correlate well with poor performance and that investors are relatively insensitive to and ignorant of fund expenses should weaken the argument that the redemption threat acts as such a constraint. It is difficult to reconcile the exceptionally high and rising profit levels of fund managers with an assertion that the redemption threat suffices to discipline fund managers. An evaluation of the reasons for these seeming market imperfections must await further study.²²⁵

²²⁰ See Gilson & Kraakman, *supra* note 71, at 987-88.

²²¹ See 15 U.S.C. § 80a-18(f).

²²² See Roe, *Political Elements*, *supra* note 74, at 1506.

²²³ See Wang, *supra* note 1, at 1007; see also Coffee, *supra* note 144, at 1288-89.

²²⁴ Of course, no such constraint exists for closed-end funds. The lack of effective managerial constraints might contribute to the persistent discounts at which such funds trade. See *supra* text accompanying notes 38-40.

²²⁵ One study found the market for money-market funds to be competitive. See BAUMOL ET AL., *supra* note 7, at 111-25. However, because money-market funds are a more homogeneous product than, e.g., equity funds, these results may not apply outside the money-market fund context.

One possible explanation for the phenomena of high and rising fees and investor insensitivity to price and performance is that the proliferation of mutual funds (see *supra* text accompanying notes 7-11), which may have resulted from the antipyridding rule, has given some fund advisers a degree of monopoly power due to product differentiation. See MONOPOLISTIC COMPETITION THEORY: STUDIES IN IMPACT (Robert E. Kuenne ed.) 160-64 (1967); WALTER NICHOLSON, INTERMEDIATE MICROECONOMICS AND ITS APPLICATION 455-

VI. *A World Without the Antipyridding Provision: Are Hostile Takeovers or Relational Investing Possible for Funds?*

In the absence of sections 12(d)(1) and 17, is it possible that funds could take sufficiently large stakes in other funds to enable them to invigorate the fund governance process, or even to engage in a hostile takeover?

With regard to closed-end funds, the answer is clearly yes. Although they are rare and difficult to accomplish, investors have made successful hostile bids for funds trading at discounts to their net asset value.²²⁶ They have then generally forced the funds to liquidate or convert to open-end form.

It appears that no U.S. open-end fund has ever been the subject of a hostile takeover. It has been assumed that such a takeover is impossible.²²⁷ One scholar has reasoned that, because open-end fund shares are always redeemable at net asset value, it is impossible for gaps between such shares' value and their market price to develop, and that such gaps are critical to attracting acquirers.²²⁸ But would such takeovers be possible in the absence of the antipyridding rule?

To address this question, it is helpful to consider why an investment company might acquire shares in an open-end fund. The incentive for the manager of the acquirer is clear: because open-end fund management fees are generally a percentage of assets under management, a manager could increase its fees if, by investing in another open-end, it could either increase the value of

59 (1990).

²²⁶ See, e.g., BULLOCK, *supra* note 77, at 49-61 (hostile takeovers of closed-end funds during the 1930s); FREDMAN & SCOTT, *supra* note 209, at 390-95 (listing funds liquidated or converted to open-end form and discussing obstacles to takeover of closed-end funds); Klein, *supra* note 207.

For examples of such takeovers outside the United States, see Nicholas Denton, *Invesco Seeks to Oust Lazard as Manager*, FIN. TIMES (London), Aug. 6, 1996, at 17; Denton, *supra* note 209, at 18; *Never Forget the Discount*, INVESTORS CHRONICLE, Apr. 28, 1995, Fin./Bus. Sec., available in LEXIS, Nexis Library, Arcnws File (attributing reduction in average U.K. investment trusts' discount to threat of takeovers); Damian Reece, *Family Finance: Predators Stalk Small Trusts*, SUNDAY TELEGRAPH, Sept. 17, 1995, at 8, available in LEXIS, Nexis Library, Arcnws File (fund managers reorganizing trusts to fend off hostile bids); Roger Taylor, *No Room at the Investing Industry*, FIN. TIMES (London), July 19-20, 1996, Quarterly Review of Personal Finance, at 7 (Fleming decided to liquidate its high income trust under pressure from a hostile bid).

For a discussion of legal issues relating to merging funds, see Sapir & Bernstein, *supra* note 12.

²²⁷ See Coffee, *supra* note 144, at 1284 n.21 ("Only in the case of the closed-end mutual fund is a takeover even conceivable, and actual instances of such takeovers are virtually unknown."); Wang, *supra* note 1, at 978.

²²⁸ See Wang, *supra* note 1, at 978.

the assets it owned or attract additional shareholders. The former could occur if a manager, through its superior investment skill, improved a target fund's investment practices, for example, by replacing employees, or altering the fund's investment strategy.²²⁹ Alternatively, the acquiring fund might be able to reduce the target fund's operating costs by superior operating techniques and economies of scale. Hostile takeovers of closed-end funds have succeeded in doing so.²³⁰ Savings might be achieved, for example, by piggy-backing on the target fund's previous marketing efforts or by merging the target fund and the acquiring fund, enabling better utilization of record-keeping and distribution systems.²³¹ Taking advantage of tax losses through a merger of the two funds might be an additional attraction.²³² Even if the chances of improving the target fund's performance were uncertain, the risks of such an investment might be low because of the high liquidity of fund shares (which results from their redemption feature), an important consideration for the acquiring fund, which would face redemption obligations itself.

An acquiring fund could also use an interfund investment as a means of attracting additional shareholders at the parent level, and thereby expand assets under management. The prospect of improving the performance of portfolio funds, as discussed above, would be one means of doing so. The acquiring fund might also draw additional investment by offering its shareholders a package of services and risk-reward characteristics that investors would perceive as superior to other available investments. These services would include (1) additional investment management services (a professional manager that

²²⁹ While there have apparently been no instances of this occurring among open-end funds, there have been attempts to form closed-end funds that would profit by taking stakes in other closed-end funds that were trading at a deep discount, then liquidating or open-ending them. Section 12(d)(1) has of course been an insurmountable obstacle to such efforts. *See, e.g.,* Rogers, Casey & Assoc., Inc., SEC No-Action Letter, June 16, 1989, available in LEXIS, FedSec Library, NoAct File, 1989 SEC No-Act. LEXIS 754; Thomas J. Herzfeld Advisors, SEC No-Action Letter, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. ¶ 77,919 (May 16, 1985).

²³⁰ *See, e.g.,* BULLOCK, *supra* note 77, at 56; FREDMAN & SCOTT, *supra* note 209, at 393-95 (investor group purchased 30% of a closed-end fund, transferred its advisory contract to their affiliate, and reduced its expenses from 1% on all assets to 0.75% on assets below \$50 million and 0.5% on assets above that amount); *cf. No Mourners for the Deadman Funds*, *supra* note 29, at 62 (fund that had declined in value by 84% since 1993 had an expense ratio of 25.6%).

²³¹ *See supra* text accompanying note 13.

²³² *See, e.g.,* FREDMAN & SCOTT, *supra* note 209, at 392-94 (acquisition of closed-end in part to capture tax losses); *cf. Vincent Warther, Instability in Open-End Mutual Funds: An Examination of the Interaction Between Capital Gains Overhangs and Mutual Fund Inflows* (May 1997) (unpublished manuscript, on file with author).

monitors and evaluates the performance of the portfolio funds' managers) and (2) additional diversification.

Thus, there seems adequate motivation for a fund to invest in another fund in the hope of merging with it, combining operations, or at least engaging in relational investing with the goal of improving the target's performance.²³³ The idea that a fund holding company might acquire a stake sufficiently large enough to give the acquirer some control over the lower-tier was, after all, a specific concern of the proponents of the antipyramiding provision.²³⁴ Before the 1970 amendments to the Act, Fund of Funds Ltd., the foreign fund whose abuses spurred adoption of those amendments, held more than thirty percent of the shares of eight open-end funds. This amount is adequate to enable the acquiring fund to influence or control the target's management.²³⁵

VII. CONCLUSION

The discussion above suggests that section 12(d)(1) (and, to a lesser extent, section 17) have largely not achieved certain of their goals of lowering fees paid by investors and combating concentrations of financial power. In addition, the antipyramiding provision seems not well-drafted or otherwise is flawed in its rationales of redemption pressures and avoiding organizational complexity. Moreover, the provision appears to have had effects well beyond its goals. Under the guise of breaking up the power of large funds, the provision may simply have supported the growth of fund complexes and the power of fund managers. Seeking to avoid fee "layering," the provision may have eliminated one of the few constraints on managers' decisions to increase fees. Using the rhetoric of investor protection, the law may have worked to protect fund

²³³ Relational investors purchase large stakes in companies as long-term investments and then play an active role in firm management. Black & Coffee, *supra* note 213, at 2055–59. It has been suggested that institutions are poorly suited to the role of active corporate monitors because such a role conflicts with their primary mission—diversifying risk for their clients. See Smith, *supra* note 179, at 40–41. Since an investment in another fund would not diminish, and might even increase, the diversification of the acquiring fund, this objection should not present an obstacle to interfund investments.

²³⁴ See PPI REPORT, H.R. REP. NO. 89-2337, at 315 (1966) ("An unregistered foreign based fund holding company, free of any statutory limitation on the percentage of the outstanding stock of mutual funds which it may purchase for its [portfolio], can acquire very substantial or even controlling interests in its portfolio funds.").

²³⁵ See, e.g., FREDMAN & SCOTT, *supra* note 209, at 393–95 (after acquirer purchased 30% of a closed-end fund, its directors agreed to transfer the advisory contract to the acquirer's affiliate); *Forging Ahead with Funds*, EAST EUROPEAN BANKER, Aug. 1995, at 12, available in LEXIS, Nexis Library, Arcnws File (Nomura, owner of 31% of shares, forced split up of Slovak fund trading at deep discount).

management from competition. There is a need for empirical study to verify these hypotheses. And there is a need for a debate on the validity of the goals and methods of this little-examined, yet significant, provision.

